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SEC Settlement: Agency Self-Interest or Public Interest

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ARTICLES

SEC SETTLEMENT: AGENCY SELF-INTEREST OR PUBLIC INTEREST

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The Securities and Exchange Commission ("SEC") has a soul of its own. The SEC has many human characteristics including the need for security, freedom, power, expansion, and expression.[1] As with people dedicated to serving others, the SEC faces the Herculean task of ignoring its own self-interest in favor of those acts that might be in the best interest of the public that the SEC was organized to protect. The SEC is not succeeding in this task.

INTRODUCTION

The primary mission of the SEC is to protect investors and maintain the integrity of the securities markets.[2] The SEC carries out this mission

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1. Maslow's hierarchy of needs is often depicted as a pyramid consisting of five levels: the four lower levels are grouped together as deficiency needs, and the top level is termed being needs. While our deficiency needs must be met, our being needs are continually shaping our behavior. The basic concept is that the higher needs in this hierarchy only come into focus once all the needs lower in the pyramid are satisfied. Growth forces create upward movement in the hierarchy, whereas regressive forces push proponent needs further down the hierarchy. ABRAHAM H. MASLOW, MOTIVATION AND PERSONALITY (Abraham H. Maslow ed., HarperCollins Publishers 1987) (1954).

2. *See* Securities and Exchange Act of 1934, 15 U.S.C. § 78b (1994) (stating that one purpose of securities law is "to insure the maintenance of fair and honest markets");

through investigations of possible violations of the federal securities laws.[3] Once the SEC concludes that such violations have occurred, the SEC faces a decision of either litigating or settling with the alleged violator(s).[4]

If the SEC considers the public's best interest[5] when making the choice between trial or settlement, it engages in an unguided exercise.[6] Settlement, the option requiring the least SEC effort in terms of resources and risk, has been the SEC's preferred method of case resolution for many years.[7] Unfortunately, the SEC fails to demonstrate its consideration, if any, for the public interest when approaching the decision to litigate or settle. It is not coincidental that alleged violators also prefer settlement as an alternative to litigation.[8]

This article explores the SEC's self-interest in settlement as it diverges from the public interest that it is charged with protecting. It will query whether there are some instances where the agency's self-

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Securities and Exchange Commission Home Page, http://www.sec.gov (last visited Mar. 25, 2006).

3. *See* Securities and Exchange Act of 1934, 15 U.S.C. § 78d (1994); SEC v. Howatt, 525 F.2d 226, 229 (1st Cir. 1975) (stating SEC has power of "original inquiry" and "[i]t may 'in its discretion, make such investigations as it deems necessary to determine whether any person has violated or is about to violate (the securities laws)" (quoting United States v. Morton Salt, 338 U.S. 632 (1950))).

4. *See* Securities and Exchange Act of 1934 at 15 U.S.C. § 78u(a) (1994).

5. Public interest should be couched in terms of the SEC's benefits as well as societal benefits. The SEC benefits from settlement by avoiding litigation risk and potential harm to its reputation while collecting fines and interpreting the federal securities laws in an uncontested forum. The public interest in SEC settlement is broader than the SEC's interests. The public interest should include, not only concern for the SEC as an institution and the collection of fines, rather the public interest should include a societal interest in the benefits of adjudication, transparency, and corporate responsibility.

6. *See* Securities and Exchange Act of 1934 at § 78u(d) (1994).

7. The vast majority of cases settle. *See* U.S. Securities and Exchange Commission, Administrative Proceedings, *available at* www.sec.gov/litigation/admin.shtml (last visited Feb. 6, 2006) (listing orders and notices that concern settlement of administrative proceedings); Susan S. Muck et al., *Recent Trends in Securities Litigation: Perspectives from Plaintiffs and Regulators* (Fenwick & West LLP, Feb. 14, 2005), *available at* www.fenwick.com/docstore/publications/litigation/SecLit_Alert_02-14-05.pdf.

8. Kenneth B. Winer & Marc B. Dorfman, *What Corporate Counsel Should Know About SEC Enforcement*, 16 CORP. COUNS. WKLY., No. 33, 264 (Aug. 22, 2001), *available at* www.abanet.org/buslaw/corporateresponsibility/clearinghouse/02spring/36/programmat.pdf.

interest conflicts with public interest. Consider this hypothetical: Linda and Martin, a retired couple, are investors who have suffered great economic losses in the stock market. Their attorney believes that these losses are a result of Linda and Martin's reliance on Jack Grubman's analyst reports. The lawyer discovers and informs his clients that on April 28, 2003, the SEC filed civil actions to redress violations of the Securities Act of 1933, NASD Conduct Rules, and NYSE Rules against ten separate investment banks and two former research analysts, including Grubman, for issuing allegedly conflicting advice.[9]

The Commission's complaint alleges that during 1999-2001, Grubman was a Managing Director and research analyst at SSB, covering the telecommunications sector.[10] The complaint alleges that, during the relevant period, Grubman publicly issued research reports on two telecommunications companies that were fraudulent because the reports contained misstatements and omissions of material facts about the companies covered, contained recommendations that were contrary to Grubman's actual views and those of an analyst who reported to him, overlooked or minimized the risk of investing in these companies, and predicted substantial growth in the companies' revenues and earnings without a reasonable basis.[11] The complaint further alleges any or all of the following: that Grubman issued research reports on six telecommunications companies that were not based on principles of fair dealing and good faith; did not provide a sound basis for evaluating facts about these companies' business prospects; contained exaggerated or unwarranted claims about these companies; and contained opinions for which there was no reasonable basis.[12] The complaint also alleges that Grubman issued a research report that upgraded his rating on a telecommunications company and did not disclose that his objectivity had been compromised.[13]

The SEC sought a permanent injunction against Grubman, enjoining him from aiding and abetting violations of certain provisions of the federal securities laws, NASD Conduct Rules, and NYSE Rules; an accounting and disgorgement of all proceeds Grubman had obtained

9. SEC v. Bear, Stearns & Co., 2003 S.D.N.Y. Civ. 2937, *available at* http://www.sec.gov/rules /other/order-enron082503.pdf (last visited Mar. 6, 2006).

10. *Id.*

11. *Id.*

12. *Id.*

13. *Id.*

as a result of his illegal conduct, plus prejudgment interest thereon, and civil money penalties.[14]

On June 19, 2003, just two months after the SEC filed its complaint, Linda's and Martin's lawyer attempts to intervene in the Grubman civil suit on behalf of "over 12,000" allegedly aggrieved investors.[15] The District Court does not allow the intervention, citing delay and the assumption that the SEC would be pursuing the public interest aggressively.[16]

Months of negotiations among the SEC, the defendants, and various state attorneys generals culminated in the filing of twelve proposed

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14. *Id.*

15. SEC v. Bear, Stearns & Co., 2003 S.D.N.Y. Civ. 2937, at 5, *available at* http://www.sec.gov/rules/other/order-enron082503.pdf (last visited Mar. 6, 2006).

16. *Id*. The SEC's policy is to oppose intervention in accordance with § 21(g) of the Exchange Act which forbids, absent Commission consent, the consolidation or coordination of any Commission enforcement action with actions brought by others:

> Notwithstanding the provisions of § 1407(a) of Title 28, United States Code, or any provision of law, no action for equitable relief instituted by the Commission pursuant to the securities laws shall be consolidated or coordinated with other actions not brought by the Commission, even though such other actions may involve common questions of fact, unless such consolidation is consented to by the Commission.

Securities and Exchange Act, 15 U.S.C. § 21(g) (1994). Courts have broadly applied § 21(g) of the Exchange Act to preclude participation of third parties in Commission enforcement cases. *See* Aaron v. SEC, 446 U.S. 680, 717 n.9 (1980) (Blackmun, J., concurring); Parklane Hosiery Co. Inc. v. Shore, 439 U.S. 322, 332 n.17 (1979); SEC v. Sprecher, 81 F.3d 1147 (D.C. Cir. 1996); SEC v. Better Life Club of Am., Inc. 995 F. Supp. 167, 180 (D.D.C. 1998); SEC v. Qualified Pensions, Inc., 1998 U.S. Dist. LEXIS 942, at *14 (D.D.C. 1998); SEC v. McCaskey, 56 F. Supp. 2d 323, 325 (S.D.N.Y. 1999); SEC v. Wozniak, 1994 U.S. App. LEXIS 24310 (7th Cir. 1994); SEC v. Thrasher, 1995 WL 456402, at *4 (S.D.N.Y. 1995); SEC v. Bradt, 1995 WL 215220, at *1 (S.D. Fla. 1995); SEC v. Randy, 1995 WL 616788, at *3 (N.D. III. 1995); SEC v. Egan, 821 F. Supp. 1274, 1276 (N.D. III. 1993); SEC v. Electronic Warehouse, Inc., 689 F. Supp. 53, 56 (D. Conn. 1988), *aff'd sub nom*. SEC v. Calvo, 891 F.2d 457, 458 (2d Cir. 1989), *and cert. denied*, 496 U.S. 942 (1990); SEC v. Lorin, 1991 WL 155767, at *1 (S.D.N.Y. 1991); SEC v. Downe, 1994 U.S. Dist. LEXIS 2292, at *7 (S.D.N.Y. 1994); SEC v. Keating, 1992 U.S. Dist. LEXIS 14630, at *10 (C.D. Cal. 1992); SEC v. Am. Free Enter. Inst., 580 F. Supp. 270, 271 (D. Ariz. 1984); SEC v. Hansen, 1984 WL 2413, at *1, Fed. Sec. L. Rep. (CCH) ¶ 91, 426 at 98, 111 (S.D.N.Y. 1984); SEC v. Allison, 1981 WL 1667, Fed. Sec. L. Rep. (CCH) ¶ 98, 263 at 91, 702 (N.D. Cal. 1981). There are some instances where courts have allowed intervention under circumstances where the intervener does not seek to expand the scope of the Commission's inquiry. *But see* SEC v. Credit Bancorp., Ltd., 194 F.R.D. 457, 465-66 (S.D.N.Y 2000); SEC v. Hollinger lnt'l., Inc., 2004 WL 422729, at *2 (N.D. III. 2004); SEC v. Heartland Group, Inc., 2003 WL 1089366, at *2 (N.D. III. 2003).

consent judgments in the Southern District of New York.[17] The proposed consent judgments provide for both injunctive and monetary relief, and contemplate that defendant investment banks will create distribution funds to be administered pursuant to plans devised by an administrator and approved by the SEC and the District Court, and an Investor Education Fund, to be administered by a separate Administrator pursuant to a plan to be approved in the same manner.[18]

On October 31, 2003, a final judgment in the civil suit is entered by consent against Grubman and others.[19] Grubman is permanently enjoined from aiding and abetting future violations of the federal securities laws, NASD Conduct Rules, and NYSE Rules.[20] Grubman agrees to pay $15,000,000 in penalties and disgorgement.[21] In addition, on October 31, Grubman, in an SEC administrative proceeding, consents to being barred from associating with any broker, dealer, or investment adviser.[22] Grubman settles these matters without admitting or denying the SEC's allegations. [23]

This example demonstrates the conflict among the SEC's preferred method of resolution, settlement, and the public interest. The Grubman settlement focused solely on the SEC's interests by providing for the disgorgement of large amounts from the alleged wrongdoer, penalizing the firms, and barring the individuals from the industry, insuring that they would not be in a position to repeat such behavior. This is seemingly harsh punishment, and perhaps this is the full relief that the SEC would expect at trial without the risk and expense of litigation. This article explores whether the SEC, a government actor representing the public interest, has an obligation to consider factors, such as public interest and the orderly development of the law, beyond how the agency will fare at trial in terms of outcome and recovery. The results of SEC litigation are broader than the simple impact on the SEC. Litigation

17. *See* SEC v. Bear, Stearns & Co., 2003 S.D.N.Y. Civ. 2937, *available at* http://www.sec.gov/litigation/litreleases/consent18111b.htm (last visited Mar. 6, 2006).

18. *Id*.

19. *Id.*

20. *Id*.

21. *Id*.

22. *Id*.

23. *In re* Jack Benjamin Grubman, Securities Exchange Act of 1934, Release No. 48725 (Oct. 31, 2003); Investment Advisers Act of 1940, Release No. 2189, Administrative Proceedings, File No. 3-11323 (Oct. 31, 2003).

creates precedents, and is a superior method of enforcement labeling.

After SEC settlement in our case above, Linda and Martin have several options: they can file an arbitration as provided for in their brokerage agreement, they can attempt to sue Grubman and his firm in district court, and they can attempt to recover from the settlement fund.

Linda and Martin's lawyer files an arbitration[24] against Grubman on their behalf. They lose the arbitration, however, and are unable to recover because they face the difficulty of proving causation and of conducting discovery against a large international corporation. Furthermore, Linda and Martin are unable to access the SEC records gathered during the investigation, and because of the SEC settlement there are no public records and no adjudicated facts available to aid Linda and Martin's case. The public, in the form of injured investors, does not benefit from the SEC's work as these investors attempt to recover for injury.

Since October 2003, numerous individual investors unsuccessfully have attempted to recover damages for relying on various Grubman reports.[25] Almost two years later, on October 6, 2005, the first arbitration victory was recorded for a couple represented by the same firm that attempted to intervene in June 2003.[26]

Is it possible that litigating the Grubman matter would have been in the public's interest? Adjudication of this matter would have served the public's interest by creating precedent, establishing *res judicata*, and providing enforcement transparency. The SEC should not ignore these public benefits during settlement negotiations.

By settling the majority of its cases, the SEC may be placing its own interest above the interest of the investing public which it is charged with serving. Instead of making a public interest determination on the manner and terms of resolution, the SEC and the courts assume that decisions serving the best interest of the SEC are also in the best interest of the public. A distinction between the SEC's interest and the public's interest is appropriate and necessary.

In approaching the question of whether SEC settlements favor self-interest over public interest, Part I of this article examines SEC

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24. "The parties to the arbitrator's decisions are bound by it." A DICTIONARY OF MODERN LEGAL USAGE 73 (2d ed. 1995).

25. *See Investors Win $2.41M in WorldCom Case*, ASSOC. PRESS, Oct. 6, 2005, *available at* http://www.sfgate.com/cgi-bin/article.cgi?f=/n/a/2005/10/06/financial/f091746D69.DTL.

26. *Id*.

investigations that seek to highlight cases the SEC believes to have merit but that result in settlement. Part II of this article analyzes the SEC's settlement process. Part III explores public interest as it relates to settlement and discusses SEC settlement in the context of public policy. Part IV discusses the public interest in SEC settlements. Part V explores factors that impede the SEC from considering the public interest in reaching the decision to settle. Part VI of this article proposes possible solutions which can incorporate public interest into SEC settlements.

I. SEC INVESTIGATIONS ARE DETAIL-ORIENTED, WEEDING OUT THE MERITLESS CASES

There are numerous articles discussing the details of SEC investigations[27] and enforcement procedures.[28] However, few address the external and internal pressures to settle with the enforcement staff and the effect of such settlements on the development of law and the public interest.

Congress founded the SEC after the market crash of 1929.[29] Prior to the crash, approximately 20 million large and small shareholders took advantage of post-war prosperity and set out to make their fortunes in the stock market.[30] An estimated $50 billion in new securities was offered during this period, yet half became worthless.[31] After the shocking blow the Crash dealt to investors, Congress concluded that to

27. *See* Barbara Brooke Manning, *SEC Investigations and Enforcement Actions*, ALI-ABA COURSE OF STUDY (June 25, 2005); William R. McLucas, *Contact with Corporate Officers and Employees in SEC Investigations*, 9 No. 3 INSIGHTS 2 (Mar. 1995); Mark S. Klock, *A Comparative Analysis of Recent Accords Which Facilitate Transnational SEC Investigations of Insider Trading*, 11 MD. J. INT'L L. & TRADE 243, 245 (1987).

28. *See* Colleen P. Mahoney et al., *Current Developments in SEC Enforcement*, 1517 PLI/Corp. 1073 (Nov. 2005); Colleen P. Mahoney et al., *Current Developments in SEC Enforcement after Sarbanes-Oxley*, ALI-ABA COURSE OF STUDY (Aug. 26-28, 2004); David G. Tucker, *SEC Enforcement Actions Against Municipalities Blaming the Professionals No Longer Works*, 35 URB. LAW. 717 (2003).

29. U.S. SEC. & EXCH. COMM'N, THE INVESTOR'S ADVOCATE: HOW THE SEC PROTECTS INVESTORS, MAINTAINS MARKET INTEGRITY, AND FACILITATES CAPITAL FORMATION, *available at* http://www.sec.gov/about/whatwedo.shtml (last visited Mar. 6, 2006) [hereinafter INVESTOR'S ADVOCATE].

30. *Id*.

31. *Id*.

improve the economy, investors would need confidence in the markets.[32] Congress held hearings to uncover the problems and possible solutions related to the Crash. These hearings resulted in the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934, and in the establishment of the SEC in 1934.[33]

The SEC is a quasi-judicial federal law enforcement agency. Its mission is to administer and enforce the federal securities laws, to protect investors, and to maintain fair, honest, and efficient markets.[34] Pursuant to the federal securities laws the SEC carries out this mission nationwide through the work of its staff.[35] Headquartered in Washington, D.C., the SEC is led by five Commissioners who are appointed by the President and confirmed by Congress. At the end of the 2004 fiscal year, the SEC consisted of four Divisions, 21 Offices, and a staff of more than 4,000.[36] The most prominent and largest division is the Division of Enforcement ("Division"),[37] which pursues possible violations of the federal securities laws through non-public investigations. The primary goals of the Division are to (1) deter conduct violative of the federal securities laws, (2) protect investors and shareholders from the potential recidivism of securities law violators, and (3) influence and improve standards of conduct and business practices of market participants.[38] The SEC's enforcement priorities

32. *Id*.

33. *Id*.

34. Government Performance and Results Act of 1993 (the "GPRA") 31 U.S.C.S. § 1115, 39 U.S.C.S. § 2801 (1993) [hereinafter GRPA].

35. Securities Act of 1933, 48 Stat. 74 (May 27, 1933), 15 U.S.C. § 77a (1933) [hereinafter Securities Act]; Securities Exchange Act of 1934 15 U.S.C. § 78a (June 6, 1934) [hereinafter Exchange Act]; Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 through 15 U.S.C. § 80b-21 (1940) [hereinafter Advisors Act]; Investment Company Act of 1940, 15 U.S.C. § 80a-1 through 15 U.S.C. § 80a-52 (1940) [hereinafter Inv. Company Act]; Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79-79z-6 (1935) [hereinafter PUHCA].

36. GPRA, *supra* note 34.

37. U.S. SEC. & EXCH. COMM'N, 2005 PERFORMANCE AND ACCOUNTABILITY REPORT, *available at* http://www.sec.gov/about/secpar/secpar2005.pdf [hereinafter 2005 PERFORMANCE AND ACCOUNTABILITY REPORT].

38. The Commission has stated its goals even more pointedly. In fiscal 1990, its enforcement program was characterized by "record-breaking efforts to ensure that defendant(s) who violated the law suffered the most serious possible financial and professional consequences within the current limits of the federal securities laws." SEC, Budget Estimate Fiscal Year 1992, at II-3 (Feb. 4, 1991). Committee on Federal Regulation of Securities, Report of the Task Force on SEC Settlements, 47 BUS.

may shift because of changes in its budget, the Commissioners, and the financial and business environment.[39] The Division's powers are broad, and are in some ways similar to the broad investigatory powers of a Federal Grand Jury.[40]

As of 2003, the Division comprised approximately 935 attorneys, accountants, inspectors, and investigators (the "Staff")[41] located in 11 regional and district offices throughout the country.[42] Each year, the SEC seeks approval from Congress for increased funding.[43] The Division receives a significant portion of the SEC budget.[44]

LAW.1083 n.24 (May 1992).

39. Harvey L. Pitt et al., *Insider Trading and SEC Enforcement: Litigating and Settling SEC Insider Trading Enforcement Cases*, 358 PLI/LIT 43, 128 (1988). When Chairman Levitt took over, he announced a focus on Municipal Finance Pay to Play Focus, as well as a focus on Internet fraud.

40. *See* United States v. Powell, 379 U.S. 48, 57 (1964); Oklahoma Press Pub. Co. v. Walling, 327 U.S. 186, 216 (1946); United States v. Morton Salt Co., 338 U.S. 632, 642 (1950); SEC v. First Sec. Bank of Utah, 447 F.2d 166, 168 (10th Cir. 1971). The Division can, in a formal order investigation, similar to a federal prosecutor, through subpoena, compel anyone to testify, without showing probable cause or relevance. In addition, the person subpoenaed to testify before a federal grand jury or the SEC can be compelled to answer questions unless they can claim a specific privilege, such as the marital privilege, attorney/client privilege, or the privilege against self-incrimination.

41. U.S. SEC. & EXCH. COMM'N, ANNUAL REPORT 2003, *available at* http://www.sec.gov/about/annrep03 .shtml [hereinafter SEC ANNUAL REPORT 2003]. As of 2002, the Staff was compromised of 40% attorneys, 17% accountants/financial analysts, 6% investigators/examiners, 31% other professional, technical, and administrative, and 6% clerical. *Id.*; GPRA, *supra* note 34. In the years 2002-2004, the SEC experienced its largest increase in staff; the SEC hired 1,000 new employees. As of September 30, 2005, the SEC had 3,759 permanent employees. 2005 PERFORMANCE AND ACCOUNTABILITY REPORT, *supra* note 37, at 8.

42. Each Regional and District Office of the Securities and Exchange Commission carries on enforcement activities. These offices include the Northeast Regional, the Boston District, the Philadelphia District, the Pacific Regional, the San Francisco District, the Central Regional, the Fort Worth District, the Salt Lake District, the Midwest Regional, the Southeast Regional, and the Atlanta District. *See* U.S. Securities and Exchange Commission, Concise Directory, *available at* http://www.sec.gov/about/concise.shtml# regions (last visited Mar. 16, 2007).

43. SEC writes a Congressional Budget Request for the upcoming fiscal year delineating the changes from the current fiscal year. The request also explains in detail the need for changes. *See* U.S. Securities and Exchange Commission, In Brief, SEC Fiscal 2006: Congressional Budget Request, *available at* http://www.sec.gov/about/secfy06budgetreq.pdf.

44. U.S. Securities and Exchange Commission, 2004 PERFORMANCE AND

Simultaneously, the SEC has devoted more time to increasing its work with other regulatory agencies, such as the Department of Justice, state and local authorities, and self-regulatory organizations, to further enforce the federal securities laws.[45] A basic assumption of this article is that a strong enforcement program is beneficial to the securities markets and the investing public.

A. The Investigation Process[46]

Congress provided the SEC with broad statutory authority to carry out its mission through investigations and prosecution of violations.[47] The authority and the tools available for the SEC to carry out these investigations and prosecutions have increased over time.[48] When the SEC receives inquiries from the media or other sources about the existence or details of an investigation, the SEC routinely indicates that it can neither confirm nor deny the existence of an investigation.[49] All

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ACCOUNTABILITY REPORT, *available at* http://www.sec.gov/about/secpar/secpar04.pdf (last visited Mar. 6, 2006).

45. Pitt et al., *supra* note 39. Self-Regulatory Organizations ("SROs") include the New York Stock Exchange, the National Association of Securities Dealers, the American Stock Exchange, the Boston Stock Exchange, the Chicago Stock Exchange, the Philadelphia Stock Exchange, the Pacific Stock Exchange, the Municipal Securities Rulemaking Board, and the Chicago Board of Options. These organizations collaborate with the SEC in regulating daily transactions. *See* Bruce Ingersoll, *Busy SEC Must Let Many Cases, Filings go Uninvestigated,* WALL ST. J., Dec. 16, 1985, at A1.

46. *See generally* William R. McLucas et al., *A Practitioner's Guide to the SEC's Investigative and Enforcement Process*, *in* PRACTITIONERS LEGAL SERIES (Sept. 1997); Richard M. Phillips, *SEC Investigations: The Heart of SEC Enforcement Practice*, *in* THE SECURITIES ENFORCEMENT MANUAL: TACTICS AND STRATEGIES, 29-130 (Am. Bar Ass'n 1997); Tim Reason, *The Cost of Cooperating with the SEC is High: The Cost of Not Cooperating is Even Higher*, CFO MAG., Apr. 1, 2005.

47. U.S. Securities and Exchange Commission, *About the Division of Enforcement*, *available at* http://www.sec.gov/divisions/enforce/about.htm (last visited Mar. 6, 2006).

48. Securities Act § 20(a), Exchange Act § 21(a), Advisers Act § 209(a), Inv. Company Act § 42(a), and PUHCA § 18(a); 15 U.S.C. §§ 18(a), 20(a), 21(a), 42(a), 209(a) (1982).

49. *See* Kimberly Hill, *U.S. Steps Up Investigation of AOL*, NEWSFACTOR MAGAZINE ONLINE, Aug. 8, 2003, http://www.newsfactor.com/perl/story/22055.html; Neal St. Anthony, *SEC Activities May Be a Bit More Open, Thanks to Lawsuit*, STAR TRIBUNE, Oct. 29, 2005; Matthew Goldstein, *Ex-Freddie President to Cooperate With Probe*, THESTREET.COM, Oct. 23, 2003, http://www.thestreet.com/pf/markets /matthewgoldstein/10121797.html.

phases of an SEC investigation are non-public.[50]

The Division learns of possible violations of the federal securities laws from a number of sources, including, but not limited to, the Commission's inspection staff,[51] self-regulatory organizations, other securities industry sources that contact the Division, and referrals from other SEC divisions and offices or other state and federal governmental agencies.[52] Some of the most fertile sources of potential violations come from the numerous outside contacts that the Division receives, either via e-mail,[53] telephone, or letter, with the deliverers of this information being good Samaritans, disappointed and defrauded investors,[54] corporate employees, or disgruntled spouses. In addition to these channels, the Staff actively looks for signs of potential violations in the local and national media, and on the Internet.[55]

The Commission has established procedures for conducting

50. *See* 17 C.F.R. § 240.0-4 (2005) (stating that nondisclosure of information obtained in examinations and investigations). Information or documents obtained by officers or employees of the Commission in any examination or investigation pursuant to § 17(a) shall, unless made a matter of public record, be deemed confidential. 15 U.S.C. §§ 21(a), 78(q), 78(u)(a) (1982).

51. The SEC requires registered broker-dealers, investment companies, investment advisers, municipal securities dealers, national securities exchanges, and transfer agents to maintain certain books and records, and to make these available to the SEC inspection staff upon request. *See* Exchange Act §§ 15B, 15C, 17, 17A , Rules 17a-1, 3, 4; Advisers Act § 204 and Rule 204-2;Investment Company Act § 31, Rules 31a-1, 3. *See* 12 U.S.C. §§ 31, 31(a)(1), 31(a)(3) (1982); 15 U.S.C §§ 15(B), 15(C), 17, 17(A), 17a-1, 204, 204-2 (1982).

52. INVESTOR'S ADVOCATE, *supra* note 29.

53. The SEC website allows any person to file a complaint or report a potential violation by filing an online form at http://www.sec.gov/complaint.shtml, or e-mailing the enforcement department at enforcement@sec.gov. In 2005, the SEC received 76,221 complaints and opened 71,737 matters due to investor complaints. 2005 PERFORMANCE AND ACCOUNTABILITY REPORT, *supra* note 37, at 45.

54. *See* Sec. & Exch. Comm'n, *Budget Estimate Fiscal 1998 at* II-1 (1997) and others. In 1999, the SEC received a record 72,173 complaints and inquiries, up 41 percent from 1998. U.S. SEC. & EXCH. COMM'N, ANNUAL REPORT 1999, at 20, *available at* http://www.sec.gov/about/annrep99.shtml. In 2000, the SEC received 82,709 complaints up 15 percent from 1999, the year the SEC launched its online investor complaint form. U.S. SEC. & EXCH. COMM'N, 2000 ANNUAL REPORT, *available at* http://www.sec.gov/about/annrep.shtml [hereinafter SEC 2000 ANNUAL REPORT].

55. *See* Written Statement of Richard H. Walker, *Concerning Securities Fraud on the Internet* (Mar. 23, 1999), *available at* http://www.sec.gov/news/testimony/testarchive/1999/tsty0699.txt.

investigations.[56] To determine whether there are violations of the federal securities laws, generally the first step the Staff takes is initiating a preliminary inquiry.[57]

1. Matters Under Inquiry

To initiate or open a preliminary first assures, with the help of a proprietary computer system, that no other office has an open investigation regarding the matter.[58] During the Matter Under Inquiry ("MUI") phase of an investigation inquiry, the Staff attempts to collect information about the matter informally. Regulated entities, including brokers, dealers, investment companies, and investment advisors, are required to cooperate in SEC investigations.[59] The Staff might review regulatory filings, trading records, and media reports to explore allegations of violations. This phase of the inquiry is short-lived. At the conclusion of a small number of staff hours, the Staff must either convert the MUI to an investigation or close the inquiry.[60] If, during this phase of the inquiry, the Staff concludes that further investigation is necessary to determine whether there has been a violation of the federal securities laws, the Staff converts the MUI into an investigation.[61] The staff attorney assigned to the investigation may make this conversion only with the approval of a supervisor, normally the Branch Chief.[62]

56. *See* 17 C.F.R. § 202.5 (1991); 17 C.F.R. §§ 203.1-.8 (1991).

57. *See* 17 C.F.R. § 202.5(a) (1996).

58. In some instance, the Staff will precede the opening of a MUI with an informal inquiry in which the Staff checks facts and attempts to piece together preliminary information such as the corporate names and information about a particular security, or Central Registration Depository records. This process is usually very short. RICHARD D. MARSHALL, OVERVIEW OF SEC ENFORCEMENT INVESTIGATIONS, 111 (Glasser Legal Works, 2002).

59. *See* Exchange Act § 15.

60. MARSHALL, *supra* note 58.

61. *Id.*; *see* Sec. & Exch. Comm'n, *Fiscal 2006: Congressional Budget Request—In Brief*, *available at* http://www.sec.gov/about/secfy06budgetreq.pdf (last visited Feb. 12, 2007) (states that many MUIs are closed).

62. *See* Appendix A, *infra*, for Organizational Structure.

2. Investigations

The SEC can conduct an investigation on a formal or informal basis. Investigations, once initiated, can take anywhere from a few months to a few years to complete.[63] There have been several somewhat successful attempts to shorten investigation time.[64] The initial phase of a formal or informal investigation is a fact-finding inquiry that determines whether there are any violations of the federal securities laws.[65]

a. Informal Investigations

During the initial phase of an informal investigation, the Staff will request that individuals and corporate entities provide information or documents—information that can enable the Staff to determine the facts of a particular case.[66] The Staff develops the facts to the fullest extent possible through methods of fact finding, such as taking witness testimony,[67] examining brokerage records, and reviewing trading data.[68] If the Staff obtains all of the relevant information on a voluntary basis, the Staff may not need to seek a Formal Order of Investigation,

63. Table of Securities and Exchange Commission Investigations (1995-2004):

Year	1999	2000	2001	2002	2003	2004
Pending as of 10/01/FY-1	1839	1966	2240	2401	2302	2929
Opened in Fiscal Year	520	558	570	479	910	
TOTAL	2359	2524	2810	2880	3212	
Closed in Fiscal Year	393	284	409	578	283	

64. Winer, *supra* note 8.

65. MARSHALL, *supra* note 58, at 110.

66. Document requests vary from case to case. The Staff routinely requests brokerage records, telephone records, message slips, calendars, chronologies, minutes from meetings, agendas, audit reports, bank records, internal memoranda, and correspondence. Sec. & Exch. Comm'n, Website Home Page, *at* http://www.sec.gov (last visited July 4, 2007).

67. Prior to the issuance of a Formal Order of Investigation ("Formal Order"), the Enforcement staff is unable to administer an oath to a testifying witness. In this instance, a court reporter administers the oath. In all situations, the Staff is in control of the record and takes the lead in asking questions, presenting documents for examination. The witness may be familiar with the documents or not. Phillips, *supra* note 46.

68. *See supra* note 66.

discussed below. In rare instances where all related parties cooperate, a case can fully develop at this stage. Those informal investigations that show promise of leading to the discovery of violations of the federal securities laws are often converted to formal investigations.

b. Formal Investigations

The Staff must request, in writing, a Formal Order of Investigation ("Formal Order") from the Commission.[69] The Commission may consider the following factors when deciding whether to grant the Formal Order: either the need to compel documents or testimony,[70] or the need for the financial records of bank customers, or both.[71] Once the Commission issues a Formal Order,[72] the Division's staff may compel by subpoena witnesses to testify,[73] and produce books, records, and other relevant documents.[74] The Formal Order provides general information about the investigation, and designates staff members as Officers of the Commission for the purpose of the investigation.[75] These Officers are able to administer oaths during administrative

69. *See supra* note 56.

70. 17 C.F.R. § 200.30-6(c); Manning, supra note 27, at 436.

71. *See* Right to Financial Privacy Act of 1978, 12 U.S.C. 3401. The Right to Financial Privacy Act limits the ability of the government to obtain customer account records from financial institutions. Phillips, *supra* note 46, at 119.

72. Formal Orders of Investigation issued over the last five years has ranged from a low of 254 in 2003 to a high of 345 in 2000. SEC ANNUAL REPORT 2003, *supra* note 41, at 124; SEC 2000 ANNUAL REPORT, *supra* note 54, at Table 3: *Investigations of Possible Violations of the Acts Administered by the Commission*.

73. The process of taking witness testimony is dictated in part by an SEC guide. This guide ensures that the Enforcement staff is consistent in its method and procedure. It also addresses privacy issues, the various other concerns that witnesses and their counsel might have, including, but not limited to, objections and privileges. This is one example of the Commission's interest in enforcement uniformity. The SEC has also developed formalized procedures for other function including making enforcement recommendations to the Commission, method of settlements, and in some specific phrasing. This guidance is written and ensures consistency and uniformity in the documents produced by the Division of Enforcement and the Commission. *See* Phillips, *supra* note 46, at 56.

74. *See supra* note 66.

75. Copies of the Formal Order may be obtained through a controlled process outlined in Rule 7(a) of the Commission's Rules Relating to Investigations. This process helps to ensure the confidential nature of Commission investigations. 17 C.F.R. § 202.7(a).

testimony taken during the investigation. The staff may issue a subpoena anywhere in the United States, and may compel witnesses to appear at any designated place for testimony.[76]

Responding to a subpoena from the SEC can be costly and time consuming.[77] However, the response to a subpoena from the SEC should be within the period contemplated in the subpoena unless otherwise negotiated.

B. Conclusions of a Formal or Informal Investigation[78]

1. A Matter Can Be Closed without Enforcement Action

The Staff closes a number of investigations each year with no enforcement action.[79] A typical reason for closing an investigation is that the staff has failed to uncover evidence of a violation of the federal securities laws.[80] The process and length of time required to close an investigation depends on the status of the investigation. While an informal investigation can be closed by a staff member with little review, closing a Formal Order investigation is not always easy, and can take anywhere from a few weeks to a few months. The staff attorney recommending to the Division that the Formal Order investigation be closed normally presents the recommendation to the Commission in a memo, usually including therein a summary of facts, issues, and legal analysis.[81] Several levels of supervision must review and approve the memo.[82] After an investigation is closed, the Staff has the discretion to notify certain parties of the closing.[83]

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76. *See*, *e.g.*, 15 U.S.C. § 77s(c) (2002); Phillips, *supra* note 46, at 56.

77. Winer, *supra* note 8.

78. In 2000, the Commission's criminal referrals yielded sixty-four indictments and sixty-two convictions. Winer, *supra* note 8.

79. MARSHALL, *supra* note 58.

80. *Id*.

81. The scarcity of resources is rarely a sufficient reason to close a case.

82. *See* Appendix A, *infra*.

83. 17 C.F.R. § 202.5(d) (1991). In instances where the Staff has concluded its investigation of a particular matter and has determined that it will not recommend the commencement of an enforcement proceeding against a person, the Staff, in its discretion, may advise the party that its formal investigation has been terminated. Such advice if given must in no way be construed as indicating that the party has been exonerated or that no action may ultimately result from the Staff's investigation of the

2. The Staff Can Seek Authority to Institute or File an Enforcement Action[84]

Upon the completion of a thorough investigation by the Staff, if the Staff concludes that it has the evidence to prove a violation of the federal securities law, the case has merit,[85] and that it is likely to be won in a contested proceeding, the Staff will prepare to make a recommendation to the Commission seeking approval to institute an enforcement action[86] either in Federal District Court or as an Administrative Proceeding.[87]

As is the case when to closing a formal investigation without an enforcement action, the first step is to draft a memo describing the case, the Division's findings during the investigation, an analysis of the applicable law, a recommendation regarding sanctions, and a recommendation to proceed in Federal District Court or before an administrative law judge.[88] The staff considers the seriousness of the alleged offense, whether the violation was technical in nature, and the type of sanction or relief that the Staff is seeking, when deciding between a civil action and an administrative proceeding.[89] Several

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particular matter. *Id*.

84. Commission authorization to issue a formal order, to file or institute an enforcement action, or to accept an Offer of Settlement can be obtained in a number of ways. The first of these is by way of a Regular Calendar Meeting in which the Commissioners discuss and vote whether or not to issue a formal order, etc. This is particularly useful when considering important issues or complex fact patterns (rarely used for a Formal Order Memo). "*Seriatim* Consideration" is when the recommendation of the Staff is moved from Commissioner to Commissioner for their vote on the issue (is used for routine cases and those previously authorized for settlement). "Duty Officer Consideration" is when one Commissioner votes on a routine matter which requires expedited consideration, such as on going fraud, the other Commissioners vote *seriatim* to affirm the action of the Duty Officer (this is used in emergency situations). *See* 17 C.F.R. §§ 200.41-.42. (1995).

85. Weak cases, and those that lack merit, are weeded out early in the investigatory process. Marshall, *supra* note 58.

86. The SEC has civil enforcement authority; however the Commission works closely with criminal authorities when the matter is egregious. Assistance provided by the Commission can be in the form of technical assistance to taking on the form of temporarily lending staff members to that authority. MARSHALL, *supra* note 58, at 114.

87. Administrative Proceedings ("APs") are heard by Administrative Law Judges ("ALJs") employed by the Commission. See MARSHALL, *supra* note 58, at 115.

88. Winer, *supra* note 8.

89. Depending on the sanctions that the Staff is seeking, the Staff seeks approval to institute both an administrative proceeding as well as a civil action. MARSHALL, *supra*

layers of supervision review and revise the recommending memo to the Commission.[90]

a. The Wells Process

Prior to submitting the memo recommending enforcement action to the Commission, the Staff contacts the potential defendant(s) or respondent(s) and offers each one an opportunity to present a statement to the Commission stating their interests and position.[91] This contact is known as a "Wells call." During this communication, the enforcement staff usually describes the general nature of the violations that will be subject to the enforcement action, if it is approved by the Commission. The staff usually sends a detailed letter after the Wells call.[92] Sometimes the counsel for defendant(s) or respondent(s) requests a Wells meeting to better understand the allegations of the Staff and to draft a more effective response. A response to the Wells call is generally known as a Wells Submission ("Wells").[93] A Wells submission may be discoverable and admissible in subsequent litigation even though it may contain an offer of settlement.[94] Effective responses are no longer than twenty-five pages.[95] In drafting a Wells submission, counsel attempts to detail and therefore persuade the enforcement staff and the Commission to consider facts that may have not come to light during the investigation, mitigating circumstances, and deficiencies in the Staff's case, all which may decrease culpability or penalties.[96] Wells submissions rarely raise new facts or dispute the application of the law, and counsel sometimes attaches a settlement offer to the submission.

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note 58, at 114-15.

90. *See* Appendix A, *infra*.

91. Securities Act Release No. 5310 (Sept. 27, 1972); 17 C.F.R. § 202.5(c) (1991).

92. Winer, *supra* note 8; *See* David R. Chase & Neal Wilson, *When the SEC Comes Knocking: What to do when faced with an 'enforcement investigation*, BUS. L. TODAY (ABA Section of Business Law, May/June 2000), *available at* http://www.abanet.org/buslaw/blt/blt100may-sec.html.

93. *Id*.

94. *See In re* Initial Pub. Offering Sec. Litig., 2004 WL 60290 (S.D.N.Y. 2004).

95. On rare occasion, a "Wells Submission" has been done by video. *See* Order Approving Proposed Rule Change and Amendment No. 1 Relating to Regulatory Jurisdiction; Proceedings, Securities Act Release No. 34-40,568, 63 Fed. Reg. 57,340-01 (Approved Oct. 27, 1998).

96. Winer, *supra* note 8.

Upon receipt of the Wells submission, if any, the Staff drafts a response for the Commissioners' consideration and presents both to the Commission. In many instances, the Staff is also in a position to recommend the acceptance or rejection of an offer of settlement presented by the defendant(s) or respondent(s). After considering the Staff's memorandum, the Wells submission, and any settlement offers, the Commission decides at a formal meeting whether to bring an action, what type of action to bring, the persons or entities to be named as defendant(s) or respondent(s), what violations to charge, and what relief to seek.[97] The Commission approves most of the Staff's recommendations. Recently, the number of matters that the SEC is able to handle has increased,[98] as have the amounts of disgorgement and penalties obtained.

b. Commission Authorization to File a Civil Action in Federal District Court

If the Commission approves the recommendation of the Staff to file a civil action, the Staff drafts and files a complaint with a U.S. District Court. Usually, the Commission allows the Staff to issue a press release.[99] Typically, the complaints filed by the Commission are very detailed, describing the alleged misconduct, identifying the particular provisions of the federal securities laws violated, and indicating the appropriate sanctions or remedial action. These sanctions usually include an injunction prohibiting future violations of the federal securities laws.[100] The Commission can seek and obtain through court

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97. Pitt, *supra* note 39, at 130.

98. SEC Enforcement actions have held steady over time but have risen in recent years.

Year	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04
Civil Injunctive Actions	171	180	189	214	198	223	205	270	271	264
Administrative Proceedings	291	239	285	248	298	244	280	281	365	375
TOTAL	462	419	474	462	496	467	485	551	636	639

Considering the media attention given to securities fraud in recent years, 636 actions might seem like a surprisingly low number. One must consider that securities case are also brought by state regulators, US Attorneys' Offices, and private plaintiffs through civil proceedings, as well as arbitrations. Sec. & Exch. Comm'n, Website Home Page, http://www.sec.gov (last visited Mar. 6, 2006).

99. Winer, *supra* note 8.

100. Securities Act § 20(b), Exchange Act § 21(d), Advisers Act § 209(e), Inv.

order undertakings,[101] such as audits,[102] accounting,[103] or special supervisory arrangements.[104] Additionally, the SEC often seeks civil monetary penalties[105] and disgorgement.[106] The courts may also bar or suspend an individual from serving as a corporate officer or director.[107]

The civil proceeding is like any other case in any U.S. District Court; briefs, interrogatories, depositions, documentary discovery, and motion practice all culminate in a civil trial. The SEC's trial counsel in the regional offices, or trial attorneys from Headquarters usually handle trials.[108] But, there are instances when staff attorneys assist in the presentation of their case at trial.[109]

c. Commission Authorization to Institute an Administrative Proceeding

If the Commission approves the Staff's recommendation to institute an Administrative Proceedings ("AP"), the Secretary of the Commission signs an Order Instituting Proceedings ("Order") and sends it to the parties.[110] Typically, the Order filed by the Commission describes the

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Company Act § 42(e), and PUHCA § 18(f). 15 U.S.C. §§ 20(b), 18(f), 21(d), 42(e), and 209(e) (1982).

101. Exchange Act § 21(d)(5), 15 U.S.C. § 21(d)(5).

102. *See* INVESTOR'S ADVOCATE, *supra* note 29.

103. *Id.*

104. *Id.*

105. *See* Exchange Act § 21(d)(3), 15 U.S.C. § 21(d)(3) (indicating that the SEC has the authority to impose civil monetary penalties); Securities Act § 20(d), 15 U.S.C.§ 20(d) (noting that civil monetary penalties can be imposed as well as the permitted amounts); Advisers Act § 209(d), 15 U.S.C. § 209(d) (explaining the civil action monetary penalties); Inv. Company Act § 42(e), 15 U.S.C. § 42(e) (citing the monetary penalties for civil actions); Exchange Act § 21A(a), 15 U.S.C. § 21A(a) (1982) (explaining the insider trading penalties).

106. *See* Exchange Act § 21(d)(5), 15 U.S.C. § 21(d)(5) (1982) (explaining the order of disgorgement).

107. *See* Exchange Act § 21(d)(2), 15 U.S.C. § 21(d)(2) (explaining the authority of the court to prohibit individuals from serving as officers); Securities Act § 20(e), 15 U.S.C. § 20(e) (stating that the commission can suspend a corporate officer).

108. Trial counsel are approximately 10% of the enforcement staff in the regional offices. The northeast regional office has approximately 60 staff attorneys and 3 trial counsels.

109. These opportunities have been most notable in the Northeast Regional Office.

110. *See* 17 C.F.R. § 201.200 (1996) (stating that when the Commission institutes proceedings appropriate notice will be given to each party); Neil S. Lang & Robyn J.

misconduct and alleges the violations of particular provisions of federal securities laws. The Order also indicates the sanctions or remedial measures sought. The Commission can seek a variety of sanctions through the administrative proceeding process including, but not limited to, a cease-and-desist order,[111] suspension or revocation of a broker-dealer's or investment adviser's registration, a censure, bar from association with a broker or dealer or investment adviser, payment of civil monetary penalties,[112] and disgorgement[113] of ill-gotten gains.

Administrative Proceedings differ from civil actions in Federal District Court. An administrative law judge ("ALJ") hears administrative proceedings.[114] The ALJ presides over a hearing and considers evidence presented by the parties.[115] ALJs follow more relaxed evidentiary standards than judges in civil proceedings.[116] After the hearing and submission of briefs, the ALJ issues an initial decision that contains findings of fact, legal conclusions, and an order that often contains a sanction, if any is given. Both the Division staff and the respondent may appeal the entire, or any portion of, the initial decision to the Commission. The Commission may affirm the decision of the

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Lipton, *Litigating Administrative Proceedings: The SEC's Increasingly Important Enforcement Alternative, in* THE SECURITIES ENFORCEMENT MANUAL: TACTICS AND STRATEGIES, 239-304, 282-83 (Am. Bar Ass'n 1997) (explaining the administrative proceedings procedure).

111. *See* Exchange Act § 21C(a), 15 U.S.C. §21C(a) (explaining the cease-and-desist order proceedings); Securities Act § 8A(a), 15 U.S.C. § 8A(a) (stating the procedure for cease-and-desist orders); Advisors Act § 203(k)(1), 15 U.S.C. § 203(k)(1) (indicating the process for cease-and-desist orders); Inv. Company Act § 9(f)(1), 15 U.S.C. § 9(f)(1) (noting the cease-and-desist procedure).

112. *See* Exchange Act § 21B, 15 U.S.C. § 21B (indicating the commission's authority to assess money penalties); Advisors Act § 203(i), 15 U.S.C. § 203(i) (explaining that the Commission can prohibit a person from acting as an employee); Investment Company Act § 9(d), 15 U.S.C. § 9(d) (noting that the commission can impose a censure and suspend an employee).

113. *See* Exchange Act § 21B(e), 15 U.S.C. § 21B(e) (explaining that the Commission has the authority to require disgorgement); Securities Act § 8A(e), 15 U.S.C. § 8A(e) (noting that the Commission can impose disgorgement); Advisors Act 15 U.S.C. § 203(k)(5), 15 U.S.C. § 203(k)(5) (stating that the Commission can order disgorgement); Investment Company Act § 9(e), 15 U.S.C. § 9(e) (explaining that the Commission has the authority to apply disgorgement).

114. Lang, *supra* note 110, at 248.

115. *See id.* (indicating that role of the Administrative Law Judge).

116. *See id.* (stating that the ALJ's fact finding role can provide benefits that the federal court judge cannot).

ALJ, reverse the decision, or remand it for an additional hearing. Either side may appeal the decision of the Commission to the United States Court of Appeals for the District of Columbia or to the court of appeals for the circuit in which the party resides or has its principal place of business.[117]

II. THE SEC SETTLES MOST OF ITS ENFORCEMENT MATTERS

The SEC settles most enforcement actions by consent,[118] pursuant to which the defendant(s) or respondent(s) neither admits nor denies the findings of fact and conclusions of law, but agrees to the entry of an injunction or order.[119] Offers of settlement are normally made in connection with the Wells Process.[120] The Enforcement Staff does not have the power to settle matters and therefore must seek such authority from the Commission.[121]

A. Process

When making a recommendation to the Commission, the Staff can seek authority to do a number of things in contemplation of settling a civil action[122] or an administrative proceeding.[123] The Staff can ask for

117. *See* Exchange Act § 25(a)(1), 15 U.S.C. § 25(a)(1) (indicating where parties can appeal the Commission's decision); Securities Act 15 U.S.C. § 9 (noting the place that parties can appeal the Commission's order).

118. *See* Richard M. Phillips, *Settlements: Minimizing the Adverse Effects of an SEC Enforcement Action*, *in* THE SECURITIES ENFORCEMENT MANUAL: TACTICS AND STRATEGIES, 179-200, 181, 190 (Am. Bar Ass'n 1997) (stating that over 90% of the enforcement actions are settled and the defendant must consent to the settlement and promise not to admit or deny the allegation).

119. *See* Milo Geyelin, *SEC Cracks Down on Denials Made After Consent Pacts*, WALL ST. J., Nov. 8, 1993, at B2 (noting how the Commission handled the defendant or the defendant's lawyers denial of allegations post settlement).

120. *See* Phillips, *supra* note 118, at 190 (explaining the Wells submission process).

121. *See* 17 C.F.R. § 202.5(f) (indicating that the authority rests with the Attorney General not the SEC or its staff to institute, conduct, settle or dispose of criminal proceedings).

122. In contemplation of settling a civil action, the Staff can seek authority from the Commission to do a number of things: authorization to file a complaint in a United States District Court and simultaneously settle the case, or authorization to file a complaint in a United States District Court, but delay the filing pending settlement negotiations. The Staff can seek the ability to conduct settlement negotiation for a

approval to engage in settlement discussions before initiating the enforcement matter in hopes of initiation and simultaneously settling. The Staff can also present to the Commission a Settlement Offer from the defendant(s) or respondent(s) and recommend to accept or not to accept the offer. The SEC, in arriving at a settlement, has wide discretion in the choice of what "terms" it imposes for the protection of investors, and ordinarily a court will not substitute its judgment of what would be appropriate terms for the Commission's judgment.[124]

Sometimes, the Staff will discuss the phrasing of the allegations or findings of fact in the settlement. The Staff may also consider inserting

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prescribed period of time after which the Staff would be authorized to file the complaint. When the Staff seeks to initiate a civil action and settle the matter simultaneously, the Staff must forward to the Commission a signed Offer of Settlement for approval. If the Commission approves the institution of the case and the settlement, the Staff will file a settled civil injunctive action in a United States District Court. Approval of Offers is usually done by the Commission on a *seriatim* basis. The defendant will agree to a final judgment, without admitting or denying the Commission's allegations.

123. In contemplation of settling an administrative proceeding, the Staff can seek authority from the Commission to do a number of things: authorization to institute and simultaneously settle a matter, or authorization, but delaying the institution of proceedings pending settlement negotiations. The Staff can seek the ability to conduct settlement negotiation for a prescribed period of time, after which the Staff would be authorized to institute proceedings. When the Staff seeks to institute and settle the matter, they must forward to the Commission an Order Making Findings and Imposing Remedial Sanctions, as well as signed Offer(s) of Settlement for approval. Approval of Orders and Offers is usually done by the Commission on a *seriatim* basis. Unlike Orders Instituting Proceedings, the Staff's reference to facts and violations in Order Making Findings and Imposing Remedial Sanctions are referred to as findings. When the Staff and the defendant or respondent agree upon settlement terms, the Staff will draw up the settlement documents for signature, and will forward these documents to the Commission with a recommendation to accept or reject the Offer. In cases where proceedings are instituted and settled simultaneously, the Order will be titled "Order Instituting Proceedings, Making Findings, and Imposing Sanctions" and the same language will be used. The Commission holds the view that failure or refusal to admit is the same as a denial, and therefore settlement would not be possible. It is worth noting that upon discovery, that a Respondent is taking action to deny the finding the Division may be able to petition the Commission to vacate the Order and to reinstitute the administrative proceeding. *See* Milo Geyelin, *SEC Cracks Down on Denials Made After Consent Pacts*, WALL ST. J., Nov. 8, 1993, at B2 (noting how the Commission handled defendant or the defendant's lawyers denial of allegations post settlement).

124. Shawmut Ass'n v. SEC, 146 F.2d 791, 796 (1st Cir. 1945); Am. Power & Light Co. v. SEC, 141 F.2d 606, 612-13 (1st Cir. 1944) (explaining that the Commission has the power of review).

language about cooperation by a defendants or respondents with the investigation if applicable. Usually, the enforcement staff drafts the Offer of Settlement for the signature of the Respondent.[125] An Offer of Settlement requires certain language developed by the Staff. This language covers topics such as prior adjudication, suspensions and bars, and the description of violations. Sometimes the Staff finds this language in the SEC Procedural Rules.[126] In other cases, the Staff incorporates the language and requires it as a form of best practices.

B. Settlement Documents/The Language of Settlement

In any civil lawsuit[127] brought by the Commission, or in any administrative proceeding[128] of an accusatory nature pending before the Commission, the SEC attempts to avoid creating, or allowing to be

125. SEC Proc. Rules 240(b); *see generally* SEC Proc. Rule 240 (1991) (noting that the signature of Counsel is unacceptable. If the settling party is a corporation, the Offer's signatory must possess a corporate board resolution authorizing the execution of the Offer); *see generally* 17 C.F.R. § 201.240 (stating that the offer of settlement must be signed by the person making the offer not be counsel).

126. The SEC Procedural Rules outline required language about *ex parte* and prejudgment waivers. *See* SEC Proc. Rules 240(c)(4)-(5); 17 C.F.R. § 201.240(c)(4)-(5) (1991). There are certain items that must be admitted by the respondent to secure settlement, including the Commission's jurisdiction and prior injunctions or convictions.

127. *See e.g.*, SEC v. Qwest Comm. Int'l, Litigation Release No. 18936 (Oct. 21, 2004), *available at* http://www.sec.gov/litigation/litreleases/lr18936.htm (stating that Quest consented to judgment without admitting or denying allegations); *see also e.g.*, SEC v. Dean Foods, Litigation Release No. 18884 (Sept. 14, 2004), *available at* http://www.sec.gov/litigation/litreleases/lr18884.htm (noting that the defendant agreed not to admit or deny allegations after consenting to settlement).

128. An administrative proceeding must include:

> Without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondent(s) consents to the entry of this Order Instituting Administrative Proceedings Pursuant to § 12(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

Investment Advisers Act of 1940, Release No. 1811 (Aug. 2, 1999), *available at* http://www.sec.gov/litigation/admin/ia-1811.htm. This sentence contains both the collateral estoppel language and the "without admitting or denying" language. *See e.g.*, *In re* Energy Equities, Order Instituting Proceedings Pursuant to §§ 203(e), (f), (k), Investment Advisers Act of 1940, Release No. 1811 (Aug. 2, 1999), *available at* http://www.sec.gov/litigation/admin/ia-1811.htm.

created, an impression that a decree is being entered or a sanction imposed when the conduct alleged did not, in fact, occur.[129] Accordingly, the Commission has a policy not to allow a defendant or respondent to consent to a judgment or order that imposes a sanction while denying the allegations in the complaint or order for proceedings. In this regard, the Commission equates a refusal to admit the allegations with a denial, unless the defendant or respondent states that he neither admits nor denies the allegations.[130] The Division, in accordance with this policy, has developed language attempting to prevent a respondent from consenting to an order imposing sanctions while denying the findings in the order.

The Staff views certain conduct as a breach of the agreement of the defendant(s) or respondent(s) not to deny the allegations of the findings.[131] The SEC reserves the right to petition the Court (in the case of a civil action) or the Commission (in the case of an AP) to vacate the Final Judgment or Order and restore the action or proceeding to its active docket.

The Order Making Findings and Imposing Sanction in an administrative action also contains what has become known as the collateral estoppel language.[132] The required language of the respondent(s) when settling an Administrative Proceeding is: "Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party." The Division avoids taking a stance on the issue of collateral estoppel preferring to leave the matter, when it arises, to subsequent courts.

The Division has used this language for many years. As discussed in Part III below, respondent(s) fear(s) the threat of collateral estoppel.

A number of knowledgeable sources have reviewed and explained the mechanics of SEC settlement.[133] However, these sources largely fail to touch on whether the wisdom of SEC settlement furthers the public

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129. 17 C.F.R. § 202.5(e) (1991).

130. *Id*. (explaining how the Commission interprets refusal to admit and denying).

131. This conduct includes taking action or allowing others to deny the allegations or findings, creating the impression that the Final Judgment or Order is without a factual basis, or failing to withdraw all papers filed in defense of the action, which tends to deny the allegations of findings.

132. Jeffrey B. Maletta & Neil S. Lang, *Sanctions and Collateral Consequences: The Stakes in SEC Enforcement Actions*, *in* THE SECURITIES ENFORCEMENT MANUAL: TACTICS AND STRATEGIES, 168-72 (Am. Bar Ass'n 1997).

133. *See supra* notes 46 and 110.

interest.

III. THOUGH PUBLIC POLICY FAVORS PRIVATE SETTLEMENTS, THIS PRIVILEGED STATUS SHOULD NOT BE PRESUMED TO APPLY TO SEC SETTLEMENTS

The SEC, as an agency committed to protecting the public interest, should uphold its obligation, even in settlement, to protect the public.

Public policy favors settlements emerging from "Traditional Settlement Environments" as described below. In most civil cases, equal parties enter into good faith negotiation motivated to arrive at a compromise agreement, thus avoiding the time, cost, emotional toll, and risk of trial.[134] Civil settlement has no impact on third parties, and is similar to a contractual agreement between the parties.[135] One party makes an offer, the second party must accept the offer, and there must be consideration exchanged. If the terms of the contract or settlement are legal, reasonable, constitutional, and in accord with public policy, the contract or settlement will be valid.[136]

A strong and established public policy favoring the private settlement of disputes also reduces the number of trials.[137] This public policy is deeply embedded in, and actively encouraged by, our civil justice system, which has as its primary objective "the just, speedy, and inexpensive determination of every action."[138] The courts encourage settlements through various court-mandated self-help programs, including mediation.[139] Generally, courts embrace settlement as a method to clear busy dockets and as an acceptance of the will of the parties.[140]

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134. Phillips, *supra* note 118.

135. *Id.*

136. *Id.*

137. *See generally* Judith Resnik, *Whose Judgment? Vacating Judgments, Preferences for Settlement, and the Role of Adjudication at the Close of the Twentieth Century*, 41 UCLA L. REV. 1471, 1477 (1994) (discussing the "myriad of contemporary developments that promote, as a matter of public policy, the settlement of disputes and the diminution of the role of formal adjudication").

138. *See* Civil Justice Reform Act of 1990, 28 U.S.C. § 471 (1995) (giving the "just, speedy, and inexpensive resolution of civil disputes" as one purpose of civil justice expense and delay plans).

139. *See generally* Resnik, *supra* note 137, at 1477.

140. *Id.* (noting that settlements are viewed as mechanisms to decrease case loads

The public's preference for private settlement, although generally accepted, should not be inferred in the area of public settlement without close scrutiny. Such uninformed application fails to explore public policy or public interests as they apply to or inform government settlements. The framework used to examine public policy interests in governmental settlements should be distinct and separate from the framework used to examine private settlements.

The agency's position purports to reflect a strong public interest dimension.[141] However, the tangible and intangible factors influencing SEC settlements are so distinct from the Traditional Settlement Environment that SEC settlements should be scrutinized more closely as to whether these settlements should be favored by public policy. For our purposes, there are three hallmarks of favored settlements or Traditional Settlement Environments: the resulting settlement has no impact on third parties; there are good faith negotiations between equal parties; and the parties are motivated to resolve the dispute. SEC settlements share none of the characteristics found in Traditional Settlement Environments. Settlement discussions with the SEC diverge from Traditional Settlement Environments in many areas which merit examination and suggest that SEC settlements should not enjoy the favor of public policy.

A. In Traditional Settlement Environments, the Resulting Settlement Has No Impact on Third Parties

In Traditional Settlement Environments, settlement does not greatly impact non-parties. The privileged status assigned to private settlements should not be thoughtlessly transferred to SEC settlements, which have the impact, if not the objective, of affecting the behavior of non-parties.

Unlike private settlements where the parties attempt to resolve their current dispute, the SEC, in settlement, attempts to give guidance to non-party market participants while benefiting its self-interest. SEC settlements affect the development of law and influence other market participants who might be subject to discipline. Unlike private litigants, the SEC bases its settlement offers on an inherent desire to affect the rights and interests of the public and of particular parties, interest

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and escape repercussions of litigation).

141. *See generally* Pierce v. SEC, 239 F.2d 160, 163 (9th Cir. 1956) ("The Commission is given the duty to protect the public. What will protect the public must involve, of necessity, an exercise of discretionary determination.").

groups, or both, who are not directly involved in the proceeding.[142] "[A] single enforcement action has the potential to effect change on an enormous scale, causing the development or enhancement of internal controls, supervisory procedures, and compliance functions at hundreds of other companies."[143]

An examination of the settlement of novel cases shows that the SEC and the courts perceive and acknowledge SEC settlements as the articulation of legal standards. The results of SEC settlements lead to the articulation and acceptance of new legal standards.

Novel cases include cases of first impression, cases seeking to clarify or refine the law, and cases which attempt to resolve or create law in areas which have not been adjudicated or where there has been no rule- making. The settlement of novel cases poses a unique threat to the orderly development of the law. These settlements create law but avoid the prescribed rulemaking process. Settlements in novel areas actually create law without the safeguards of rulemaking, adjudication, or legislation. The SEC constructs settlement language and terms with little input from the respondent, defendant, or the public. The courts and the SEC then use these settlements as precedence. This use of settlements to express a new theory or interpretation of law has been accepted.

In two related settlements, the Commission created a new legal standard. Mid-level managers must take affirmative steps to rectify those actions of their supervisors that they knew, or should have known, were improper.[144] In a settled administrative proceeding, *In re Maury, Maury*, a certified public accountant since 1974, was a Vice President and Controller of Oak Technology, Inc., a manufacturer of communications equipment and a publicly traded company from 1981 through September 1985. The court found Maury to have caused Oak Technology Inc.'s violations of certain provisions of the Federal Securities Laws based upon his participation in the preparation of Oak's financial statements.[145] The Release describes Maury's conduct as

142. *See generally id.* at 163.

143. Stephen M. Cutler, former Sec. and Exch. Comm'n Enforcement Dir., Speech at 24th Annual Ray Garrett, Jr. Corporate & Sec. L. Inst. (Apr. 29, 2004), *available at* http://www.sec.gov/news/speech/spch042904smc.htm.

144. *Id.*

145. *In re* Maury, 1986 WL 734624, at *8, Exchange Act Release No. 23067, 35 SEC Docket (CCH) 432 (Mar., 26, 1986).

follows:

> Maury did not act as a primary decision-maker with regard to the matters that have been discussed in this opinion.146 The ultimate decisions concerning the adequacy of Oak's reserves and the interaction between Oak's employees and its independent auditors were not made by Maury. However, the Commission cannot condone Maury's conduct. Maury had or had available to him more than sufficient information to be aware that the financial statements he prepared and the periodic reports he signed were materially inaccurate. Under the circumstances, and as a senior level financial officer and the highest level CPA within Oak involved in the financial reporting process, Maury owed a duty to Oak and its shareholders not to assist in, or even acquiesce in Oak's issuance of such financial statements. Although Maury may have made the appropriate recommendations to his corporate supervisors, when those recommendations were rejected, Maury acted as the "good soldier," (emphasis added) implementing their directions which he knew or should have known were improper. Moreover, Maury failed to take adequate steps to satisfy himself that the accounting practices discussed herein, were correct, and that the disclosures made by senior management were accurate. Such action could have included, among other possibilities, alerting Oak's Board of Directors, audit committee, the Commission or the independent auditors. Under the circumstances, Maury's actions clearly failed to fulfill the duty Maury owed as corporate Controller.[147]

In a related settled administrative proceeding, In re *Runge*,[148] the Commission similarly admonished Runge for acting as a "good soldier." The Commission indicates in the release that Runge should have taken steps to prevent certain misstatement in Oak's proxy materials. Runge's failure to act constituted a failure to fulfill the duty he owed as a corporate officer.[149]

A number of commentators view these settlements as a substantial departure from any existing principle of law regarding the duties of mid-level corporate managers.[150] Following these two Releases, the Commission has repeatedly held that corporate officers cannot simply

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146. An Order instituting Proceedings, Findings, and Order of the Commission is not an Opinion.

147. *In re* Maury, 1986 WL 734624, at *8.

148. Exchange Act Release No. 23066, 35 SEC Docket (CCH) 432 (Mar. 26, 1986).

149. *Id*. at 3.

150. Cutler, *supra* note 143, at 2.

act as "good soldiers" and assist or acquiesce in those acts of their superiors which they know or should know are improper. Each case expressly relied on the Oak releases as establishing the relevant precedent.[151]

In addition to using settlements to set broad standards of conduct, the SEC also uses settlements as a tool to define or interpret certain words. *In the Matter of Revlon, Inc.*, defined the term "negotiation" broadly to include any "substantive discussion" not only between the parties or potential parties, but also between their advisers and representatives "concerning a possible transaction."[152] The SEC also indicated that an assessment of when "negotiations" have started turns upon a review of all of the existing facts and circumstances. The SEC used this term in subsequent cases.[153]

In re Prudential Securities, Inc., another significant settlement, broadly impacted non-related parties.[154] The SEC alleged that the firm engaged in improper sales practices concerning the sale of direct investments to customers. Prudential settled this matter. In the settlement Prudential agreed not to assert a statute of limitations defense against any claimants who entered the claims resolution process.155 The removal of the statute of limitations represents a monumental

151. *In re* Tracy Spadaro Maynard, Exchange Act Release No. 36,022, 59 SEC Docket 2197, 1995 WL 452900, at *1 (Jul. 25, 1995); *In re* Collins Indus., Inc., Exchange Act Release No. 34,934, 57 SEC Docket 2764, 2779 (Nov. 3, 1994); *In re* Sye, Exchange Act Release No. 24534, 38 SEC Docket (CCH) 592, 593 (June 2, 1987) (stating that a corporate controller cannot escape culpability by asserting that they acted as "good soldiers" and cannot rely upon the fact that the conduct may have been condoned, even ordered by, their corporate superiors); *In re* Benny Aguirre, Exchange Act Release No. 24,535, 38 SEC Docket 847, 850 (June 2, 1987); *In re* Stewart Parness, Exchange Act Release No. 23,507, 36 SEC Docket 395, 408-09 (Aug. 5, 1986) (stating that a corporate officer cannot avoid liability merely by following the directives of his or her corporate supervisors).

152. *In re* Revlon, Inc., Exchange Act Release No. 23,320 (June 16, 1986); *see In re* Lionel Corp., Exchange Act Release No. 30,121 (Dec. 30, 1991), at 7-8.

153. *In re* RIT Acquisition Corp., 50 SEC 1004, Release No. 30,732, Release No. 34-30732, 51 SEC Docket 828, 1992 WL 120493 (May 22, 1992).

154. *In re* Prudential Sec., Inc., Exchange Act Release No. 33,082, 55 SEC Docket 720 (1993).

155. SEC v. Prudential Sec., Inc., Litigation Release No. 13,840, 55 SEC Docket 709, 1993 WL 430407, at *1-4. Another unique term of settlement was that Prudential would establish a fund, with an initial deposit of $300 million, to compensate customers who choose to use a modified claim procedure.

change in the civil system of recovery. This tool of procedure often presents a significant hurdle to litigants and the SEC removed this obstacle in this instance. The settlement also contained many dictates about firm practices and policies. This settlement was meant to impact non-related third parties.

Within the past decade, the Commission has issued orders in cases involving several large securities firms. The Commission determined that these firms failed reasonably to supervise persons within their employ, in violation of Section 15(b)(4)(E) of the Exchange Act.[156] The Commission has used these cases to comment extensively on what it deems to be the responsibilities of all firms, their management, and their compliance staff to establish minimum standards of supervision.[157] For example, the Commission has cited with approval the Smith Barney matter at least 30 times. The Commission referred and relied on its order in the Smith Barney matter in *In the Matter of Prudential-Bache*[158] and in *In the Matter of Shearson Lehman*,[159] where the Commission discussed the compliance procedures required of each firm. The Commission also prominently quoted the Smith Barney order in a staff legal bulletin to remind the securities industry that the Commission's views on the responsibilities of brokers to supervise their employees have been known for some time.[160]

More recently, these same settled cases have begun to appear in decisions against persons who have decided to contest the allegations against them. In February 1998, the National Adjudicatory Council NASD Regulation, Inc. cited the Smith Barney matter in a contested case.[161]

In sum, the Commission has demonstrated a pattern of relying on its own articulations of legal principles to establish substantive rules of law, intended for general, prospective application. The development of law and the articulation of binding legal standards should be reserved for one of the accepted methods of law making, such as administrative rule

156. *In re* Smith Barney, Securities Exchange Act of 1934 Release No. 21,813 (Mar. 5, 1985).

157. *In re* Fidelity Brokerage Servs., LLC., SEC Release No. 50,138 (Aug. 3, 2004).

158. *In re* Prudential Bache Sec., Inc., Releaser No. 34-22755 (Jan. 2, 1986).

159. *In re* Lehman Bros., Exchange Act Release No. 37,673 (Sept. 12, 1996).

160. Staff Legal Bulletin No. 17 (Remote Office Supervision), 2004 WL 3711970, (Mar. 22, 2004).

161. *In re* Mkt. Regulatory Comm. Complaint v. La Jolla Capital Corp., 1998 WL 1084575, at *1-6 (N.A.S.D.R.).

making,[162] legislation, or through adjudication.[163] But courts and the Commission both cite to settled matters as authority. Occasionally, the SEC has asserted, based on settled matters, that bad actors were on notice of the Staff's position regarding certain conduct or interpretation of the law. The Supreme Court[164] and the Second Circuit[165] both give weight to SEC consent decrees, which suggests that the application of legal interpretations by the SEC in non-contested consent decrees is authoritative and serves to instruct and put the securities industry on notice. The Commission and the Courts should not use settlements as legal precedents in subsequent actions because those conclusions, without going through a rulemaking process or adjudication, are not precedents. The SEC should advance novel cases through administrative rulemaking or adjudication. SEC settlements are a form of precedent, as significant as an opinion from the Commission or a federal judge to potential defendant(s) or respondent(s).

Generally, everyone accepts that the Staff protects the public interest and safeguards the securities markets. This responsibility includes investigating possible violations of the federal securities laws which will negatively impact the public and the markets, and

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162. *See generally*, Exchange Act § 23(a)(1), Securities Act § 3(b), 15 U.S.C. § 77c(b), *and* Exchange Act § 10(b), 15 U.S.C. § 78j(b), 15 U.S.C. § 78w(a)(1) (1988), 15 U.S.C. § 78c(b); 15 U.S.C. §§ 3(b), 10(b), 23(a)(1), 77(c)(b), 78(c)(b), 78(j)(b), 78w(a)(1) (1988).

163. SEC v. Chenery Corp., 332 U.S. 194, 203 (1947) (noting that every case of first impression has a retroactive effect, and held that making policy by means of adjudication is not per se an abuse of discretion because of such effect). Additionally, the Court acknowledged that there is . . . a very definite place for the case-by-case evolution of statutory standards. *Id.* Moreover, the choice made between proceeding by general rule or by individual, ad hoc litigation is one that lies primarily in the informed discretion of the administrative agency. *Id. See also* CBS v. United States, 316 U.S. 407, 421 (1942).

164. E.I. DuPont de Nemours & Co. v. Collins, 432 U.S. 46, at 54 (1977) (citing F.T.C. v. Mandel Bros., 359 U.S. 385, 391 (1959)) ("[C]ontemporaneous construction of a regulatory statute by the agency charged with its administration is entitled to great weight . . . even though it was applied in cases settled rather than by litigation.").

165. United States v. Chiarella, 588 F.2d 1358, 1369 n.17 (2d Cir. 1978), rev'd, 445 U.S. 222 (1980) (citing United States v. Persky, 520 F.2d 283, 288 (2d Cir. 1975)). All that is necessary for adequate notice is that "a clear and definite statement of the conduct proscribed" antedate the actions alleged to be criminal. *Id.* Under this principle, Chiarella manifestly had adequate notice that his trading in target stock could subject him to criminal liability. *Chiarella*, 588 F.2d at 1369 n.17.

prosecuting and seeking sanctions, including disgorgement, against those whom the SEC finds in violation of the federal securities laws. Query whether the protection of the public interest as opposed to Agency self-interest should extend to the method of determining the form of prosecution; settlement or public adjudication.

SEC settlements should be a three party process. One sphere should contain the SEC, who protects the public and the integrity of the securities markets by stopping and detecting bad actors. The second sphere should contain the individual/corporate defendant(s) or respondent(s) who want to settle charges quietly and economically. The third sphere should contain the public interest.[166] SEC settlements affect the public in a many ways. Since the SEC has an opportunity to engage in unilateral rule making through settlement and SEC settlement can conflict with public interest, we must examine whether the SEC can properly protect the public interest in settlement negotiations.

SEC settlements depart from the Traditional Settlement Environment. This departure leads to corruption of the settlement process. SEC settlements do not compare to settlements favored by public policy, which emerge through traditional settlement environments. We need an alternative framework to evaluate whether the SEC properly protects the public interest through settlement. A framework for evaluation is preferable to assuming that SEC settlements are favored by public policy. SEC settlements both deviate from Traditional Settlement Environments and impact non-parties. Neither the courts, nor the Commission, should adopt settlements as precedent because this treatment would circumvent the creation of law through legislation, adjudication, or administrative rule making.

B. Public Policy Favors Settlements Between Equal Parties Negotiating a Resolution

In Traditional Settlement Environments, settling parties are equally equipped to negotiate with one another to arrive at a mutually agreed upon resolution. These parties act in good faith to arrive at a resolution. A hallmark of a Traditional Settlement Environment is that the parties have equal bargaining power or are "relative equals."[167] For instance,

166. *See* Phillips, *supra* note 46, at 56 (stating that the public includes small investors, corporations, and individuals, and this sphere may also include the judiciary legislatures, and others concerned with the orderly development of the law).

167. There is case law in the area of contracts that discusses unequal bargaining

when considering a dispute between two neighbors over a fence or a property line, the relative equal standard is instinctual. The parties have an interest in the outcome and are similarly situated. A settlement between two relatively equal parties represents an exercise in private ordering, and the law accepts the results as the will of the parties.[168]

The "relative equal standard" becomes more unstructured when applied to settlement negotiations between individuals and corporations, or between individuals or corporations, and government entities. The parties to the settlement are clearly different and appear to be unequal. A litmus test for our societal notion of power would make the evaluation of the status of the parties easier.

Defining power in terms of negotiating ability sheds some light on the status of the negotiating parties. Parties who are equals in terms of negotiating ability would presumably have a similar amount of power at the bargaining table. There are as many definitions for as there are sources of power.[169] Power could be defined as one party's ability to influence or coerce the opposing party into agreement. No one definition of power has proven its universal applicability.[170]

A non-exclusive list of the characteristics of power includes: wealth, authority, strength, persuasion, capacity, influence, a willingness to engage in conflict, and other less visible factors. Resources, like manpower and economic strength, give organizations like the SEC power to assert preeminence in the regulatory field. The SEC sits as the primary drafter, interpreter, and rule and regulation enforcer, and claims various moral, intellectual, political, or economic legitimacy.[171]

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power as a part of the doctrine of unconsionability and the avoidance of contracts of adhesion. U.C.C. § 2-302; RESTATEMENT (SECOND) OF CONTRACTS § 208 (regarding treatment of inequitable bargaining power as a factor toward a successful unconscionabilty defense). Williams v. Walker-Thomas Furniture Co., 350 F.2d 445, 449 (D.C. Cir. 1965) (holding that unconscionablility includes the absence of meaningful choice).

168. Few scholars have attempted to define private ordering with any measure of success. Professor Fuller has defined private ordering as "law" that parties bring into existence by agreement. *See* Robert H. Mnookin and Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950, 950 n.1 (1979).

169. *See generally* Daniel D. Barhizer, *Inequality of Bargaining Power*, 76 U. COLO. L. REV. 139, 153 (2005) (discussing "the nature of power").

170. *Id.*

171. JEFFEREY PFEFFER, POWER IN ORGANIZATIONS 2, 4-6 (1981) (discussing transformation of raw power into legitimate authority).

Additionally, the SEC might find a source of power in its perceived relationship with Congress and the Judiciary. There is also the power of coercion vested in the SEC. The SEC coercively exerts pressure on industry participants to settle in the name of cooperation and to avoid negative labeling. An additional source of power might come from the SEC's ability, through settlement, to withhold investigatory or damaging documents from the public.[172] When we examine possible inequalities in bargaining power, we must also make assumption about party motivations and goals.

1. SEC Settlement with Individuals, and Small and Mid-Sized Enterprises

Unlike settlements between private parties who may be in equal positions of strength, during an SEC settlement the SEC has more bargaining power than most of its opposition. The parties are not equals. SEC investigations exhaust the resources of the respondent(s) or defendant. The strength of the SEC comes from the nature of the investigative process as well as the SEC's statutes. These factors serve to embolden the SEC and the Staff in the negotiation process.[173]

The investigative process empowers the SEC by allowing the staff to focus exclusively on one enforcement matter for long periods of time, making a solid case theory as well as evidence. This process equally diminishes the bargaining or negotiating position of respondent(s) or defendant(s) who must respond to SEC inquiries and requests while managing ongoing business endeavors. The potential defendant(s) or respondent(s) must divert work hours and resources from normal activities in order to respond to the SEC's requests for documents and testimony. Most entities and individuals involved in an SEC investigation also employ outside counsel for representation during the investigation. This investigation process can continue for months. The SEC, through sanctions, can close businesses and end careers. Considering the perceived status of the SEC, the Agency has little incentive to settle for less than it could obtain in an enforcement action.

The inequality between the SEC and potential respondent(s) or defendant(s) helps explain the SEC's "take all" approach to settlement.

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172. Certain documents would become part of the public record through litigation. Such disclosure is generally avoided through settlement.

173. The SEC's position of strength increases as the size, power, influence or wealth of the potential defendant or respondent goes down.

When considering settlement, the Enforcement Staff looks for terms that provide all of the desired relief including, but not limited to, penalties, bars, disgorgement, and suspension if applicable.[174] Thus, settlement with the SEC does not look like a negotiated settlement.

Arguably, the SEC, in a settlement, receives as much in terms of sanctions as it does in a contested proceeding, without as many work hours, and without the diversion of resources from other enforcement matters. Previously, the Securities Defense Bar considered settlement at the conclusion of a SEC investigation to be in the best interest of the defendant(s) or respondent(s). However, as the Staff seeks higher and harsher sanctions, defendant(s) or respondent(s) chose to litigate matters. As a result, a higher number of settlements should be seen after the commencement of an administrative matter or civil proceeding but prior to trial.

The SEC is more powerful than most respondents or defendants, and oftentimes presents most of these parties with settlement documents for their signature. The respondent(s) or defendant(s) have two options: settlement or litigation. Defendant(s) or respondent(s) cannot realistically walk away from the settlement nor do they have a realistic ability to modify the terms.[175] SEC settlements with individuals and small to mid-sized enterprises are not the result of a good faith negotiation between two equal parties. SEC settlements go beyond settlements favored by public policy; SEC settlements are not private ordering or necessarily an expression of the will of the parties.

2. SEC Settlement with Large Corporations Including Securities Firms: Where Does Its Power Lie?

A query about the bargaining position of the SEC vis-à-vis large brokerage firms and other major industry participants poses unique challenges. The power imbalance, if any, is less obvious between the parties. It appears that the SEC has no more leverage than a large financial institution or large corporation in terms of economic wealth, political power, or intellectual power. But, if these parties are in an

174. *See generally* Phillips, *supra* note 118.

175. Stirlen v. Supercuts, Inc., 60 Cal. Rptr. 2d 138, 146 (Cal. Ct. App. 1997) (holding employment contract to be oppressive and procedurally unconscionable because employee did not have a meaningful opportunity to negotiate, despite that fact that he was able to secure several favorable terms in the agreement).

equal bargaining position, how does the SEC extract unprecedented settlements from these parties?[176]

Notwithstanding the mutual advantages, SEC settlements are not agreements between equals. We must evaluate hidden power and the power of coercion to understand the bargaining ability of each side. Unfortunately, these types of power are not obvious, particularly if unused. Unspoken coercive power and other hidden powers held by each side influence SEC settlements with large and powerful financial institutions. Unspoken yet strong factors that might play a role in defining the power relationship between the SEC and large financial institutions are: (1) large financial institutions and the law firms that represent them heavily employ former SEC staff, (2) the compliance and

176. Between early 2004 and fall 2004, the SEC imposed fifteen penalties over $50 million, including may of the highest penalties ever obtained in SEC enforcement actions. Stephen M. Cutler, *Speech; The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program* (Sept. 20, 2004), *available at* http://www.sec.gov/news/speech/spch092004smc.htm. *See* SEC v. WorldCom, Inc., 273 F. Supp. 2d 431 (S.D.N.Y. 2003) (imposing a $2.25 billion penalty, satisfied post-bankruptcy at $750 million); *In re* Merrill Lynch & Co., Litigation Release No. 18038, 79 SEC Docket 2533 (Mar. 17, 2003), *available at* http://sec.gov/litigation/litreleases/lr18038.htm; *In re* Citigroup, Inc., Exchange Act Release No. 48230, 80 SEC Docket 2116 (July 28, 2003), *available at* http://sec.gov/litigation/admin/34-48230.htm; *SEC Charges J.P. Morgan Chase In Connection With Enron's Accounting Fraud*, Litigation Release No. 18252, 80 SEC Docket 2286 (July 28, 2003), *available at* http://sec.gov/litigation/litreleases /lr18252.htm (stating that SEC imposed a total of $197.5 million in civil penalties, and substantial disgorgement, against Merrill Lynch, Citigroup, JPMorgan Chase, and CIBC); *see*, *e.g.*, *In re* Invesco Funds Group, Inc., Investment Company Act of 1940 Release No. 26629, 83 SEC Docket 2872 (Oct. 8, 2004) (imposing a $110 million penalty), *available at* http://www.sec.gov/litigation /admin/34-50506.htm; *In re* Alliance Capital Management, L.P., Investment Advisers Act of 1940 Release No. 2205A, 81 SEC Docket 3401 (Jan. 15, 2004) (imposing $100 million penalty), *available at* http://www.sec.gov/litigation/admin/ia-2205a.htm; *In re* Massachusetts Financial Services Co., Investment Advisers Act of 1940 Release No. 2213, 82 SEC Docket 341 (Feb. 5, 2004) (imposing $50 million penalty), *available at* http:// www.sec.gov/litigation/admin/ia-2213.htm; *In re* Pilgrim Baxter & Associates, Investment Advisers Act of 1940 Release No. 2251, 83 SEC Docket 363 (June 21, 2004) (imposing $50 million penalty), *available at* http://www.sec.gov/litigation /admin/ia-2251.htm; *In re* Putnam Investment Management, LLC, Investment Advisers Act of 1940 Release No. 2226, 82 SEC Docket 2225 (Apr. 8, 2004) (imposing $50 million penalty), *available at* http://www.sec.gov/litigation/admin/ia-2226.htm; In re Janus Capital Management LLC, Investment Advisers Act of 1940 Release No. 2277, 83 SEC Docket 1766 (Aug. 18, 2004) (imposing $50 million penalty), *available at* http:// www.sec.gov/litigation/admin/ia-2277.htm.

legal areas of large financial institutions and the firms that represent them are normally staffed by former SEC staff, (3) the financial institutions in avoiding litigation also avoid suits by the investing public; and (4) the SEC is self-interested.

The trend toward increased settlement from large corporations and financial institutions would seem to indicate that the SEC has more power than respondent(s) or defendant(s) in these cases. But, first we must address the coercive power and hidden factors that contribute to the imbalance of power. An analysis of the motivation below does seem to indicate that the respondent(s) or defendant(s) have more to lose than to gain in litigation. Maybe the threat of future collateral estoppel forces large corporations and financial institutions to engage in SEC settlement.

C. Public Policy Favors Settlements When the Parties Are Motivated to Avoid the Time, Cost, Emotional Toll, and Risk of Trial

In Traditional Settlement Environments, the parties are equally motivated by certain considerations, including, but not limited to, the avoidance of the time, cost, emotional toll, and risk of litigation. These considerations exact a cost of the parties who resort to litigation. These costs are immeasurable, and the impact on the courts is significant.

The societal and individual benefits of settlement emerging from the Traditional Settlement Environment, instead of litigation, are impossible to quantify. Most negotiators engage in a cost benefit analysis. They weigh the financial costs of litigation versus the economic value of settlement. Generally, the expense, risk, and delay that frequently attend formal adjudication explain, at least in part, a party's preference for, and the rising incidence of, settlement.[177] Settlement should promise a speedy resolution and enhanced party satisfaction.[178]

Party motivation toward SEC settlement varies greatly from the motivations leading toward settlement in the Traditional Settlement

177. Laurie Kratky Dor, *Secrecy by Consent:*T*he Use and Limits of Confidentiality in the Pursuit of Settlement*, 74 NOTRE DAME L. REV. 283, 290 (1999); Samuel R. Gross & Kent D. Syverud, *Don't Try: Civil Jury Verdicts in a System Geared to Settlement*, 44 UCLA L. REV. 1, 3-5 (1996) (explaining the American legal system's preference for settlement with structural reasons such as "scarcity of judges and abundance of lawyers, adversarial fact-finding, and trial by jury").

178. *Id.*

Environment. The motivations in SEC settlement are less noble than the general aversion of cost, emotional toll, and the risk of trial. Agency self-interest and the opposing side's desire to avoid collateral estoppel are the primary factors encouraging SEC settlement.

1. Potential Motivations Toward Settlement for the Defendants' or Respondent(s)

Fear of reputation and economic harm, and the collateral estoppel effect of a trial, motivate potential defendant(s) or respondent(s) in an SEC settlement.[179] Defendant(s) or respondent(s) might feel internal or external pressures to settle quickly. The business and investing communities perceive institutions and individuals who choose to defend against the SEC's allegations as bad actors. The opposite is true for those who settle SEC enforcement actions.

Defendant(s) or respondent(s) must concern themselves with two possible negative outcomes associated with contested SEC matters, reputational and economic harm and the significant risk of collateral estoppel, both of which could attach if the defendant(s) or respondent(s) loses the SEC enforcement matter.

a. Avoidance of Reputational and Economic Harm

The first type of harm associated with an SEC enforcement matter, reputational and economic harm, can be devastating if not managed by the defendant(s) or respondent(s) properly. Even though SEC investigations are nonpublic, leaks do occur.[180] These leaks are often more damaging to a corporate image or individual reputation than any sanction that might be imposed in a contested proceeding. Public awareness of an SEC investigation requires corporate crisis management and communication.[181] Engaging in a contested proceeding with the SEC, however, can increase harm to an individual or corporation for any number of reasons including, but not limited to, the expense of

179. The coercive motivation often is felt by small and mid-sized enterprises or individuals. This motivation is omitted from this discussion. *See* Part III.B.1.

180. *See* Phillips, *supra* note 46; *see also* 17 C.F.R. § 202.5(a) (1996). It is believed that most leaks are the result of testimony witnesses' discussions and are rarely attributed to the Staff. The staff policy is neither to confirm nor deny the existence of any investigation.

181. *Id.*

defense,[182] prolonged negative media attention,[183] and the redirection of corporate efforts and resources from daily management to defending against the enforcement proceeding.

The harm associated with a contested proceeding can be minimized through a simultaneous filing of the complaint or order and a settlement.[184] Settling with the SEC allows the defendant(s) or respondent(s) to resume normal business as soon as possible and to manage the negative publicity at one time, as opposed to confronting waves of negative publicity at the time of filing, through the trial, and at the resolution of the matter. Another public relations reason to settle an enforcement matter is the possibility that the SEC staff will allow the settling defendant(s) or respondent(s) to review and comment upon the settlement documents.[185]

Public sentiment related to corporate reputation impacts consumer trends as well as the share price.[186] Harm to a company's reputation can quickly morph into long-term economic harm for a corporation or an individual. In 2000, when Microsoft was found to have exploited its monopoly powers and ordered to break up, its share price fell sharply.[187] Microsoft's recovery of market capitalization is still in progress, six years later, even though the charges were settled and the breakup was avoided.[188] In 2002, when investors discovered that the SEC and the U.S. Attorney were investigating Computer Associates International, its share price fell by half within days.[189] Computer Associates' share price has just begun to reach levels comparable to the 2002 prices. In 2002, Merrill Lynch suffered a $20 billion loss of market capitalization.[190]

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182. *Id.* The expense of defending a SEC Enforcement matter can be crippling because the SEC can choose to devote substantial Staff hours and other resources to a case that the Staff or Commission deems important. The cost is even greater when you consider the expenses incurred during the investigation process.

183. *Id.* Prolonged negative publicity of this sort can have an adverse impact on share price, employee morale, business planning, and sales.

184. *Id.*

185. *Id.*

186. *Id.*

187. *Id.*

188. Michael Bobelian, *Companies Accused of Wrongdoing Often Settle Quickly*, BROWARD DAILY BUS. REV. 7 (Dec. 8, 2004).

189. *Id.*

190. Ronald J. Alsop, *Corporate Reputation: Anything but Superficial*, 25 J. OF BUS. STRATEGY 21 (2004), 2004 WLNR 15864092 at *1.

The loss is attributable to three corporate scandals: (1) the analyst scandal, (2) the company's ties to Enron, and (3) the company's connection to Martha Stewart.[191] In 2003, Martha Stewart Omnimedia, Inc. lost 16% in market capitalization on reports of possible criminal and civil charges against Martha Stewart in connection with selling her ImClone stock.[192] During the investigation, Martha Stewart Omnimedia, Inc. lost half of its value.

There is a value attached to corporate reputations because public sentiment, more so than corporate fundamentals, move the securities markets. The reputational and economic harm which attend an SEC enforcement matter can not be underestimated. The avoidance of market share loss is a possible motivation for respondent(s) and defendant(s) to settle quickly SEC matters.

b. Avoidance of Collateral Estoppel[193]

Of the two possible types of harm, the second associated with an SEC enforcement matter, possible exposure to collateral estoppel, is most feared by large corporations. Plaintiffs can use collateral estoppel, also known as issue preclusion, to prevent an unsuccessful defendant in an SEC enforcement matter from re-litigating certain issues decided against that defendant in the first case.

Issue preclusion bars from litigation issues that were litigated and determined. These particular issues will be barred from relitigation between the actual parties as well as all other litigants.[194] Issue preclusion is applicable when (1) an issue of fact or law is (2) litigated and determined by (3) a valid and final judgment and (4) the determination essential to the judgment.[195] Issue preclusion contributes to judicial efficiency and enhances consistency because the doctrine precludes relitigation of issues already decided in an earlier suit and avoids the possibility of inconsistent outcomes. In the past, only the same parties in a subsequent suit could use issue preclusion. However,

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191. *Id.*

192. *Id.*

193. Collateral estoppel is also known as issue preclusion. *See* BLACK'S LAW DICTIONARY 179 (6th ed. 1991).

194. *See* Parklane Hosiery Co. v. Shore, 439 U.S. 322 (1979); RESTATEMENT (SECOND) OF JUDGMENTS § 29 (1982).

195. *See* Gargallo v. Merrill Lynch, 918 F.2d 658, 664 (6th Cir. 1990) (stating that this requirement cannot be met through settlement).

in 1942, the mutuality rule in the application of issue preclusion was abandoned in most jurisdictions[196] and nonmutual collateral estoppel began its rise.

Nonmutual collateral estoppel conserves judicial time and resources while enhancing fairness.[197] Plaintiffs who are unhappy with verdicts may no longer press their case until potential defendants run out.[198] In addition, defendants who have lost are precluded from ignoring the decided issues in a prior case.[199]

Offensive nonmutual collateral estoppel is the tool that private litigants would use after a successful SEC enforcement action. Assuming that (1) an issue of fact or law was (2) litigated and determined by (3) a valid and final judgment and (4) the determination was essential to the judgment, the determination would be conclusive in a subsequent action brought by aggrieved investors. The Supreme Court has suggested that subsequent plaintiffs should not be able to use issue preclusion "in cases where a plaintiff could easily have joined in the earlier action . . . ."[200] Private plaintiffs may seek to join SEC enforcement actions; however, the SEC as a policy opposes such joinder.[201] The investors in the subsequent action would be able to use

196. *See* Bernhard v. Bank of America Nat'l Trust & Savings Ass'n, 122 P.2d 892 (Cal. 1942).

197. RESTATMENT (SECOND) OF JUDGMENTS § 27 (1982).

198. *See* Blonder-Tongue Lab., Inc. v. Univ. of Ill. Found., 402 U.S. 313 (1971) (stating that defensive non-mutual estoppel is present in suit number one when the plaintiff loses on a certain issue; in suit number two against defendant two, plaintiff is precluded from arguing the recurring issue lost in suit one).

199. *See id*. (stating that offensive non-mutual estoppel: in suit one defendant loses on a certain issue; in suit number two against plaintiff number two can use collateral estoppel against the same defendant from suit number one to establish the recurring issue in suit number one without re-litigation).

200. Parklane Hosiery Co. v. Shore, 439 U.S. 322, 331 (1979).

201. *See In re* Jack Benjamin Grubman, Securities Exchange Act of 1934, Release No. 48725/Oct. 31, 2003; Investment Advisers Act of 1940, Release No. 2189/Oct. 31, 2003, Administrative Proceedings, File No. 3-11323; Jack Benjamin Grubman, SEC Consent of Defendant Jack Benjamin Grubman, SEC v. Bear, Stearns & Co., 2003 S.D.N.Y. Civ. 2937, *available at* http://www.sec.gov/litigation/litreleases/consent18111b.htm (last visited Mar. 6, 2006) (citing SEC v. Canadian Javelin Ltd., 64 F.R.D. 648, 651 (S.D.N.Y. 1974)) (denying intervention of right and noting that "Congress has entrusted the SEC with the responsibility for protecting the public interest"); *accord* Natural Res. Def. Counsel, Inc. v. New York State Dep't of Env't Conservation, 834 F.2d 60, 62 (2d Cir. 1987) (affirming district court's denial of both

offensive nonmutual collateral estoppel against the same defendant in the SEC enforcement action to establish the recurring issues without relitigation. This ability would increase the power of the securities plaintiff's bar tenfold.

The Supreme Court has granted courts broad discretion in applying offensive nonmutual collateral estoppel.[202] There are three significant factors to consider when examining the validity of collateral estoppel: (1) whether the defendant had a full and fair opportunity to litigate the issue in the first proceeding, (2) whether the court was fair in its determination in the first proceeding, and (3) whether there have been changes in the law since the first proceeding. SEC settlements void the public's opportunity to use offensive nonmutual collateral estoppel because settlements are not actually litigated.

The motivation of defendant(s) or respondent(s) for SEC settlement has little to do with whether the conduct in question is right or wrong. The motivation is purely economic: the avoidance of future litigation with perhaps numerous private litigants, relying on collateral estoppel, and the speedy reestablishment of business as normal. The interest of the defendant(s) or respondent(s) in settlement as a form of resolution in lieu of litigation is the avoidance of collateral estoppel. The desire to avoid this negative outcome is so great that the rules of law articulated in the settlements releases are more closely akin to a one-sided dissertation of the facts and law than it is a true advancement of principled reasoning through the use of precedents.[203] Very few negatives can be found for the settling defendant(s) or respondent(s) beyond the terms of settlement that can include a variant of sanctions that arguably would be no different from those imposed in a litigated proceeding.

In settling matters, the Commission has responded to the defendant(s) or respondent(s) collateral estoppel fear by inserting language into settlement documents that favor the defendant(s) or

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permissive intervention and intervention of right, noting that "though this is not a case where a governmental entity is suing as *parens patriae* . . . the fact that the suit is being defended by the combined legal forces of the United States and the State of New York" supports the conclusion that the "interests of [the proposed interveners] are adequately represented") (internal citations omitted). *See also supra* note 16 and accompanying text.

202. *Parklane Hosiery Co.*, 439 U.S. at 322.

203. *Report of the Task Force on SEC Settlements*, 47 Bus. L. 1083, 1041 (May 1992).

respondent(s).[204] The largest beneficiary of an SEC settlement is/are the potential defendant(s) or respondent(s).

2. The SEC's Motivation for Settlement

The SEC's enforcement program seeks to promote the public interest by protecting investors and preserving the integrity and efficiency of the securities markets.[205] The SEC does not consider the various public interests into the decision to settle any particular matter. Unfortunately, the SEC's interest in settlement has more to do with the agency self-interest concerns of internal cost savings and risk aversion, as opposed to the motivations favored by public policy in the Traditional Settlement Environment—the speed of reaching a mutually negotiated conclusion, or the impact on or benefit to the public.

Any consideration of the legitimacy of SEC settlement as the primary method of enforcement case resolution should explore the SEC's motives. Numerous factors encourage SEC settlement. Several of these factors could be termed legitimate, while other factors could be viewed as illegitimate as they relate to public policy or public interest.[206]

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204. *Id*. (explaining that the Division hopes to avoid taking a stance on the collateral estoppel effects of its proceedings and settlements; the Order Making Findings, and Imposing Sanctions will also contain what has become known as the collateral estoppel language).

205. SEC ANNUAL REPORT 2003, *supra* note 41, at 1.

206. Congress has charged the Commission with protecting the investing public. *See*, *e.g.*, 15 U.S.C. § 78j(b) (referring to "rules and regulations . . . the Commission may prescribe . . . for the protection of investors"). *See* Pierce v. SEC, 239 F.2d 160, 163 (9th Cir. 1956) ("The Commission is given the duty to protect the public. What will protect the public must involve, of necessity, an exercise of discretionary determination."). In theory, the SEC has experience determining what is in the public interest and representing this interest. The SEC, in its Memorandum of Law in Opposition to Motion to Intervene in SEC v. NJ Affordable Homes Corp. and Wayne Puff, 2005 WL 3523260 (D.N.J. 2005), indicates that the Commission is responsible for litigating in the public interest. *See also* Jack Benjamin Grubman, SEC Motion and Order, SEC v. Bear, Stearns & Co., 2003 S.D.N.Y. Civ. 2937, *available at* http://www.sec.gov/rules/other/order-enron082503.pdf (last visited Mar. 6, 2006) (denying plaintiff the right to intervene in an SEC enforcement matter on the basis that the SEC represents the public interest.). The agency is required to make public interest determinations is a number of different situations. *See* Rules of Practice for the Securities and Exchange Commission 200(c): Initiation of Proceedings (regarding the time and place of the hearing shall be fixed with due regard for the public interest);

The prevalence of such settlements indicates that in settlement the SEC follows formalistic norms as opposed to evaluating the public interest. The SEC's status as a government actor representing the public interest is an idyllic description. The SEC represents its "self-interest" and settlement is pragmatic. Pragmatism, however, does not determine if these routine settlements comport with public policy or serve the public interest. SEC settlement benefits the agency. The conservation of resources, risk avoidance, expansion of jurisdiction, and impact on legal norms play a prominent role in the decision to settle.

A definition of agency self-interest must be developed to examine whether the SEC makes settlement decisions based on its own self-interest considerations instead of public interest considerations. The agency is a collection of people, some interested in any or all of the following: justice; victory; reputation; and political gain. Agency self-interest is most visible when agency actions and decisions attempt to place the articulated goals and priorities of the agency over all other interests.[207]

Rules of Practice for the Securities and Exchange Commission 193: Applications by barred individuals for consent to associate, preliminary note (stating that the Commission will consider the nature of the findings that resulted in the bar when making its determination as to whether the proposed association is consistent with the public interest); Rules of Practice for the Securities and Exchange Commission 192 Rulemaking: Issuance, Amendment and Repeal of Rules of General Application (stating that except where the Commission finds that notice is contrary to the public interest); Rules of Practice for the Securities and Exchange Commission 102(e)(3)(i): Appearance and Practice Before the Commission ("The Commission, with due regard to the public interest . . . ."). When imposing certain sanctions, the SEC is required to consider public interest and must make a showing that the imposition of certain sanctions is in the public interest. Maletta, *supra* note 132 (listing sanctions that include a revocation of registration as a broker or dealer or adviser, bar of a person from association with such an entity, suspension from an association with a regulated entity, limitation on activities and censure). The question of the appropriate remedy is an issue for administrative competence. *See* Butz v. Glover Livestock Commission Co., 411 U.S. 182, 185 (1973) (quoting American Power & Light Co. v. S.E.C., 329 U.S. 90, 112 (1946) (internal quotation marks omitted); Phelps Dodge Corp. v. N.L.R.B., 313 U.S. 177, 194 (1941) ("The relations of remedy to policy is peculiarly a matter for administrative competence . . . ."). As a result, and traditionally the Commission's interpretation of the public interest and the resulting sanctions must be affirmed unless "unwarranted in law or . . . without justification in fact." Rizek v. SEC, 215 F.3d 157, 160 (1st Cir. 2000) (quoting American Power & Light, 329 U.S. 90, 112-13 (1946)).

207. The articulated goals can come from Agency leaders, Agency priorities (Internet cases), Congress (e.g., Sarbanes-Oxley), or the President.

a. Conservation of Resources

The SEC caseload is enormous, and SEC settlement plays a role similar to mediation or other forms of court mandated attempts at alternative dispute resolution. The SEC settles most of its enforcement cases. Settlement conserves resources which would be expended during the adjudication of a contested proceeding.

Each year, the SEC requests and receives additional Congressional funding for staff salaries, hiring, training, and equipment.[208] During fiscal year 2002, Congress increased the Commission's initial appropriation of $437.9 million to $514 million.[209] The Commission also received a supplemental appropriation of $30.6 million to hire 125 new attorneys and accountants and to address technology needs.[210] Congress enacted the fiscal year 2003 appropriation, in late February 2003, resulting in an operating budget of $711.7 million. For fiscal year 2004, the SEC received authority to spend $811.5 million.[211] Fifty-three percent of that funding went to the Division of Enforcement.[212] The SEC requested appropriation of $888.1 million for fiscal year 2006.[213] Over the last several years, Congressional funding has increased to meet the needs of the SEC.[214] Arguably, these positive changes[215] make the agency's lack or conservation of resources a less compelling argument

208. *See generally* ANNUAL REPORTS of the SEC. & EXCH. COMM'N, *available at* http://www.sec.gov/about/annrep.shtml (last visited Mar. 6, 2006).

209. *See* SEC. & EXCH. COMM'N, GOVERNMENT PERFORMANCE AND RESULTS ACT—2004 ANNUAL PERFORMANCE PLAN; 2002 ANNUAL PERFORMANCE REPORT (Mar. 2003) at 11, *available at* http://www.sec.gov/about/gpra2004_2002.pdf (last visited July 4, 2007).

210. *Id.*

211. SEC. & EXCH. COMM'N, ANNUAL REPORT 2004, at 14, *available at* http://www.sec.gov/about/ secpar/ secpar04.pdf [hereinafter SEC ANNUAL REPORT 2004].

212. SEC. & EXCH. COMM'N, *Fiscal 2006: Congressional Budget Request*, In Brief, http://www.sec.gov/about/secfy06budgetreq.pdf (last visited Mar. 6, 2006).

213. *Id.*

214. Staff salaries, hiring, training, and equipment have each increased in the last several years. In fiscal year 2002, 7,300 training sessions were attended. In fiscal year 2003, 4,803 training sessions were attended. Between 2002 and 2004, the SEC saw its highest hiring increase of 1,000 new employees. SEC ANNUAL REPORT 2003, *supra* note 41; SEC ANNUAL REPORT 2004, *supra* note 211.

215. The salary, staffing, training, and other improvements at the agency level may help to explain the increased number of cases. *See* Maletta, *supra* note 132.

to justify wholesale settlement.

b. Avoid Litigation Risk and Possible Reputational Harm

The Commission's interest and posture in settlement is often attributed to the design of the investigatory process, which encourages thorough investigations. The quality and quantity of staff hours, documents reviewed, and witness testimony result in a confident and knowledgeable enforcement staff. The staff can present a persuasive case leading to a positive outcome for the Commission. However, the threat of reputational and programmatic harm that can result from a litigation loss is a significant motivator toward settlement.

In examining the impact of possible litigation risk and reputational harm to the agency, we should assume that the agency and staff are motivated to stop harm to investors, and that the Staff only seeks approval from the Commission to proceed when faced with winnable cases. We must also assume that the Staff does not bring cases for the purpose of coercing settlements.

Assuming that the SEC brings winnable cases and the Commission's goal is to protect investors and serve the public interest then the SEC should experience great success in contested matters. A review of SEC cases suggests that the SEC fairs better in terms of positive outcomes in settlement and in contested administrative proceedings than it does in civil litigation. Litigation risks the uncertainty of a result (since the SEC could and does lose) that can be avoided by settlement.[216] The effects of losing a contested proceeding, particularly a novel case, are far reaching.

A recent survey of SEC cases points to anecdotal evidence that the SEC is most successful when it is pursuing its core areas of enforcement, such as standard account fraud cases and insider trading cases.[217] The SEC does not fare as well in areas beyond its "core

216. Report of the Task Force on SEC Settlements, 47 BUS. L. 1083, 1093 n.28 (May 1992). *See*, *e.g.*, Dirks v. SEC, 463 U.S. 646, 662 (1983) (reversing SEC censure, applying a "personal benefit" analysis to determine tipper/tippee liability); Aaron v. SEC, 446 U.S. 680 (1980) (ruling against the SEC on the issue of scienter in Rule 10b-5 cases); SEC v. Peters, No. 88-1720-K (D. Kan. 1990) (finding the defendant not guilty on charges of insider trading).

217. *Hitting Home Runs and Missing? Examining How the SEC Has Fared in recent District Court Litigation*, ALI-ABA, at 711, 714 (July 20, 2006) [hereinafter *Hitting Home Runs*].

competency," including, but not limited to, market timing and primary and aiding and abetting liability for market timing, secondary actor liability, scienter required for lying to auditors, insider trading,[218] and viatical settlements. The survey suggests that the SEC's mixed results when it has sought to expand the reach of its enforcement practice might explain its lack of aggression in these novel areas of law.[219]

c. The SEC Strategically Increases Its Power Through Settlement

The SEC's popular support and bargaining strength are enhanced through settlement activity. The SEC and Congress are often pressured by popular sentiment to act in response to market factors and scandals. For example, market timing rules, The Sarbanes-Oxley Act, and the creation of the PCOAB are areas of regulation that were a reaction to popular scandal. The SEC and Congress' swift response to popular scandal increases popular sentiment.

An examination of the parties' motives for settlement reveals that settlement is a win-win proposition for the SEC and the defendant(s) or respondent(s). Unfortunately, the SEC pays little attention to the public interest in SEC settlements process.220 There is no guidance, which suggests that the SEC or the courts make a public interest determination when conducting and entering settlement negotiations. SEC settlement may very well be appropriate in a host of cases and for a variety of reasons. However, the SEC and the judiciary should recognize a public interest in SEC settlements.

IV. THE PUBLIC INTEREST IN SEC SETTLEMENTS SHOULD BE DEFINED

Examining the public interest in SEC resolution requires that the public interest be described, if not defined. Defining the public interest in any one area is often difficult. The public interest in the financial markets and in investor protection is referenced in several works. Public

218. These crimes are noted as part of the SEC's core competency. However, the SEC has attempted to prosecute an individual who would not normally be subject to liability, a barber who was given insider information. S.E.C. v. Maxwell, 341 F. Supp. 2d 941 (S.D. Ohio 2004).

219. *See Hitting Homeruns*, *supra* note 217, at 714.

220. Dor, *supra* note 177 (stating that the impositions of some sanctions require that the SEC make a public interest determination).

response to current events in the financial markets can be an indicator of public interest. Negative public reaction followed by legislation in the areas of corporate ethics and accounting practices is an indicator of the public interest in corporate responsibility and in market transparency.

A. Transparency and Corporate Responsibility

SEC settlement fails as a branding tool in the area of enforcement because it fails to distinguish bad actors from those who have made technical errors or minor violations of the federal securities laws.

There have been several recent articles about the wave of corporate executives who refuse to acknowledge wrongdoing and publicly accept responsibility for their activities. A rash of high profile corporate scandals serves to highlight the necessity and public interest in corporate responsibility. Consider Rigas of Adelphia Communications Corp., Inc., Credit Suisse First Boston's Frank Quattrone, Martha Stewart and ImClone's Samuel Waksal, WorldCom's Bernard Ebbers, former CEO, Scott Sullivan, former CFO, Tyco's L. Dennis Kozlowski and former CEO, Kenneth Lay of Enron.

If we examine these financial scandals, in spite of convictions, settlements, and trials the defendant(s) are not remorseful. There has been no acceptance of responsibility or acknowledgement of guilt. In 2005, Marsh & McLennan, charged with insurance bid rigging by the New York Attorney General's office, was stuck in settlement negotiations, not by the additional $150 million that the NYAG's office was requiring for settlement, but by a required statement of contrition.[221] In October 2005, the CEO of Citibank apologized to Japanese regulators in person for his company's action, violations by Citibank's private banking group in Japan. SEC settlements are done on a "without admitting or denying" basis. This in some way allows respondent(s) or defendant(s) to maintain the appearance of innocence while paying a fine to avoid litigation. A method of labeling wrong doers in the settlement process would allow the public to make an informed decision about which companies and individuals transact business with. The swift Congressional and public response to the Enron and WorldCom scandals is an indicator of public interest in corporate responsibility.

221. *See* Geyelin, *supra* note 123.

B. There Is a Public Interest in Adjudication

Adjudication yields the following societal benefits: (1) the creation of recognized rules or precedents; and (2) the creation of the possibility of collateral estoppel. In addition to these tangible benefits of adjudication, some societal satisfaction can be derived from the adjudication process being a focus of the popular media. The result of wide media coverage can spur or enhance the public dialogue about financial fraud, investor relations, and corporate misdeeds.

1. Creation of Precedents Is in the Public Interest

The creation of precedents through adjudication is in the public interest. Adjudication creates precedents. When an unbiased arbiter analyzes the law and applies it to facts of a particular case, the same conclusion and the same analysis can be expected in future cases having the same facts. The creation of precedents avoids the necessity of revisiting the application and interpretation of every law. Precedent is a method of using the past in order to assist in current interpretation and decision-making. It allows people to have a reasonable expectation of the legal solutions that apply in a given situation. Additionally, precedents have the important role of guiding future behavior and in imposing certainty in disputed areas of law.

Precedents encourage certain efficiencies in the American dispute resolution system. The ability to reflect, utilize, and be bound by earlier cases can lead to the avoidance of litigation and might increase the frequency of private resolution. In addition, market participants aware of the precedents can adjust their behavior in recognition of a developed body of law in order to avoid conflict.

The certainty of law, transparency, and increased judicial efficiency and consistency are byproducts of the adjudication process that are in the public interest. Settlement avoids the creation of precedents, leaving behind a limited body of law with which to establish legal principles to be followed when similar or identical facts arise. Settlements should not produce precedents binding on non-parties.[222] However, as discussed earlier[223] courts as well as the SEC treat SEC settlements as precedents.

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222. Coleman & Silver, *Justice in Settlements*, 4 SOC. PHIL. & POL. 102, 114-19 (1986).

223. *See supra*, discussion at Part III.A.

The pervasive use of SEC settlements runs counter to the public interest in the creation of precedents.

2. Collateral Estoppel[224] *(a By-Product of Adjudication) is in the Public Interest*

The Supreme Court in *Parklane Hosiery*[225] approved the use of collateral estoppel by strangers to an SEC proceeding against a defeated defendant, who had an opportunity fairly and fully to litigate the Commission action. The plaintiff using collateral estoppel could prevent the defendant from defending the action on certain grounds and relitigating certain facts on a private suit. Private plaintiff's use of collateral estoppel would strengthen their ability to prevail against major financial institutions involved in complicated frauds. Non-parties would be able to seek recovery associated with the SEC's cases. Collateral estoppel could obligate the individual or corporation to public investors who without collateral estoppel were unable to pursue their rights.[226] As a result of collateral estoppel, private parties could adopt a wait and see posture with respect to defendant(s) in SEC matters.[227] It is generally accepted that federal courts may give collateral estoppel effects to findings in an administrative proceeding.[228]

It is not clear that the risks to the agency in terms of reputation, loss, and expense outweigh the benefit to the public of finality and collateral estoppel. The balancing needed to make this sort of determination is neglected in the settlement context. The resources of the agency, its ability to make law, the removal of litigation risk, and the ability to obtain significant sanctions in settlement are the primary considerations as the agency approaches settlement. Little regard is

224. *See supra,* discussion at Part III.C.1.b.

225. Parklane Hosiery Co. v. Shore, 439 U.S. 322, 322 (1979).

226. *Id.* (regarding investors that could not have joined the SEC case).

227. *See Parklane Hosiery Co.*, 439 U.S. at 322 (dissent, J. Rehnquist).

228. United States v. Utah Constr. & Mining Co., 384 U.S. 394, 421-22 (1966) (determining that findings of Board of Contract Appeals in proceeding on claim within its jurisdiction are final and conclusive with respect to a claim which is based on the same facts, but which is not within the Board's jurisdiction and is harmonious with general principles of collateral estoppel). A statement that res judicata principles do not apply to administrative proceedings is too broad, and when an agency is acting in judicial capacity and resolves disputed issues of fact properly before it which parties have had adequate opportunity to litigate, courts may apply res judicata to enforce repose. *Id.*

given to the public's interest in the adjudicatory process and its societal benefits.

V. THERE ARE PRACTICAL SOLUTIONS TO OVERCOMING THE COLLECTIVE ACTION PROBLEM INHERENT IN THE RECOGNITION OF THE PUBLIC INTEREST IN SEC RESOLUTION

It might be impossible for the SEC, comprised of the staff and the Commissioners, to consider investor protection the public interest. Divergent interests imply that the staff will be an imperfect advocate for the "public interest."[229] The Commissions and the Staff look to past settlements to determine reasonableness, impact on the public investors, deterrence, and punishment when confronted with the settlement decision. The Commission does not examine the public interest factors in this determination. There are, however, possible solutions to the incorporation of public interest considerations into SEC settlements.

A. Saying "Sorry"

We must assume that some settlements reached by the SEC in which the defendant or respondent is not required to admit or deny the allegations of wrongdoing are appropriate in certain limited circumstances. This proposition should not be true for most settlements.

SEC settlements of novel and routine[230] cases should be more strictly scrutinized by the courts, administrative law judges, and the public. The resources of the Commission would provide an acceptable justification for the settlement of routine cases, pose little litigation risk and will be settled on a "neither admitting or denying basis."[231] Settlement of routine cases without admissions of guilt harms public interest while benefiting the defendant(s) or respondent(s) through the avoidance of collateral estoppel. Cases in which the Staff predicts

229. Sanford I. Weisburst, *Judicial Review of Settlements and Consent Decrees: An Economic Analysis*, 28 J. LEGIS. 55, 93 (1999).

230. For our purposes, routine cases are those cases in an area of the law which is well settled and similar to those cases which contain principles previously tested through adjudication.

231. SEC settlements, with rare exception, contain the following language: "Without admitting or denying the findings herein, except that Respondent has admitted the Commission's jurisdiction over it and over the subject matters set forth herein, Respondent has consented to the entry of this Order." *See generally* SEC Releases.

minimal litigation risk should only be settled with an admission of guilt, responsibility, or statement of contrition from the respondent(s) or defendant(s).

In the equity markets, investors likely view the integrity and competence of management as material to investment decision-making.[232] This comment made by William McLucas is no less true today. Certainly, integrity and corporate management are important to investors. In recognition of this public interest, the SEC should require this precise information when settling. The information should be in the form of some statement of contrition or the acceptance of responsibility from respondent(s) and defendant(s) settling SEC enforcement proceedings. However, the settlement of routine cases could include some admission of guilt or a statement of contrition. The settlement of routine cases including an admission of guilt or other statement of responsibility could satisfy the Agency's self-interest as well as the public interest.[233]

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232. William R. McLucas, *Common Sense, Flexibility, and Enforcement of the Federal Securities Laws*, 51 BUS. L. 1221, 1229 (1996) (citing Roeder v. Alpha Industries Inc., 814 F.2d 22, 25 (1st Cir. 1987)) (holding undisclosed bribe as material because information could cause a reasonable investor to question competency of management); United States v. Fields, 592 F.2d 638, 649-50 (2d Cir. 1978), *cert. denied* 442 U.S. 917 (1979) (finding kickbacks received by corporate officers could be material); *In re* Franchard Corp., Securities Act Release No. 4710, [1964-66 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,113 (1964) (stating that self-dealing reflects on quality of management, which is "of cardinal importance in any business"); John M. Fedders, Law Enforcement Against Those Who Fail to Disclose Illegal Behavior, BANKING & BUS. L. (Nov. 19, 1982).

233. *Id.* Critics will suggest that the proposal is impracticable for several reasons: court systems are overburdened with costly and time-consuming litigation, SEC resources cannot support additional litigation, settlements are related to court efficiency, and public policy generally supports settlements. There is no easy solution to the burden on the federal court system; however, public interest in adjudication should not give way to an overburdened system. As for cost savings unlike private settlements where each party bears the burden of cost in an SEC litigation the defendant or respondent bears its costs and the public bears the cost of the SEC prosecution. While it is true that, public policy favors settlement and settlement is viewed as an efficiency in our system. However, the adjudication of novel cases would increase court efficiency through the creation of precedent. As for Commission and staff resources, funding for the Staff has been increasing steadily; it would seem that funds could be utilized to support an enforcement philosophy, which could include litigation in novel areas.

B. Exempt Novel Cases from Settlement

An alternative to settling novel case is to issue 21(a) reports. In the past, these reports have been used to illuminate the need for legislation while others have served to advise the public with respect to the obligations imposed by the federal securities laws.[234] In a number of instances, the publication of these reports has accompanied the institution of enforcement actions by the Commission.[235]

When the Staff brings novel cases, or cases attempting to clarify the law, the Commission engages in the creation of precedent. The Commission or the Staff can outline allegations or findings that led to the enforcement action and the sanctions appropriate for such behavior. These settlements are released publicly and are reviewed by those in the industry for indicia from the Commission as to its current enforcement policies and practices. Potential defendant(s) and respondent(s) take cues from these sources and conform their conduct as not to duplicate the prohibited behavior. In theory, this conforming behavior is not objectionable.

However, in the area of novel cases a different standard should apply. Settlements in novel cases help to shape industry behavior, serve as precedent for the commission and the industry, and essentially create rules outside of the formal rulemaking process. Restrictions on settlements will benefit the SEC and the public.

An argument against stricter policing of settlements of novel matters is that the ability to settle while clarifying the law will inhibit the SEC's ability to be nimble and respond to new areas of fraudulent tactics. With adjudication, Rulemaking, or Legislation, the SEC has been able to prosecute Insider Trading[236], initiated the foreign payments

234. Issuances of Reports and Investigations of Statements, Exchange Act Release No. 34-15664, 17 SEC Docket 18 (Mar. 21, 1979).

235. *Id.*

236. *See* United States v. O'Hagan, 521 U.S. 642 (1997). The SEC and Congress have refused to define the term "Insider Trading." This has allowed the Staff to advance insider trading from the traditional formulation, where a classic corporate insider uses information for personal gain in violation of a duty owed to shareholders of the company, to the misappropriation theory where a corporate outsider working on a transaction who trades based on information obtained in the work environment while owing no duty to any market participant or shareholder that can be found liable for Insider Trading.

program[237], prosecuted parking frauds,[238] and municipal securities pay to play schemes.[239] However, the rulemaking process is efficient and within the control of the Commission. It should be used to address novel cases and new interpretations of the laws.

C. Judiciary's Role as an Oversight Body

The role of the Judge in evaluating the protection of the public interest should be increased as a check on the settlements of the Agency in response to self-interest, and the public's inability to join suits and represent its own interest. The judiciary should explore this showing of the SEC and it should balance the self-interest of the agency and its employees against the public interest. The purpose of the court in making these inquiries is to determine whether the decree adequately protects the public interest.[240]

D. Lessons from Other Areas of Law Which Allow for the Incorporation of Public Interest.

Family law and antitrust law are two areas of the law where the incorporation of interests beyond the parties is necessary.

1. Family Law

Child custody jurisprudence can shed light on SEC settlement jurisprudence. Child custody jurisprudence goes through a decision

237. *See id.* When the Commission uncovered that corporations were making payments to foreign parties in the normal course of business and failing to disclose such payment the SEC injunctive action against several corporation for falsifying books and records to conceal these payments.

238. McLucas, *supra* note 232, at 1229. There were no specific rules that address the common practice of Parking in the 1980s. However, the SEC viewed parking as compromising the public's perception of fairness, honesty, and integrity in the securities markets.

239. *Id*. at 1229. Bribery, *quid pro quo* arrangements, political contributions, or other gratuities that affect the selection of underwriters and financial advisers, go to the heart of the municipal market's integrity. These practices may have serious implications for the overall health of public finance. The broad provisions of the anti-fraud rules have provided the SEC with a vehicle with which it can address abuses in the municipal securities market and protect investors, without a need for additional legislation.

240. *See* United States v. Ketchikan Pulp Co., 430 F. Supp. 83, 86 (D. Ala. 1977).

making process that evaluates several spheres of concern in advance of reaching a conclusion. These spheres of influence include the following: the wishes of the child, a party often unable to express his or her wishes; the wishes of each parent; the best interest of the child; and the interaction and interrelationship of the child with his parent or parents, his siblings, and any other person who may significantly affect the child's best interest. The judge "acts as *parens patriæ* to do what is best for the interest of the child. He is to put himself in the position of a wise, affectionate, and careful parent . . . and make provision for the child accordingly."[241]

Beyond child custody matters there are other matters where courts need to consider the interest of minors or incompetents. Sometimes a court might appoint a guardian *ad litem*. A guardian *ad litem* is a person appointed by the court only to take legal action on behalf of a minor or an adult not able to handle his/her own affairs. Duties may include filing a lawsuit for an injured child, defending a lawsuit or filing a claim against an estate. The attorney who is appointed guardian *ad litem* provides independent advice to the Court (as compared to the attorneys advocating for one side or the other in the action) to bring balance to the decision-making process. The guardian *ad litem* may conduct interviews and investigations, make reports to the court and participate in court hearings or mediation sessions.

The public, similar to a child or an incompetent person, has problems expressing its interests in SEC settlements. There are practical barriers,[242] and collective actions problems which prevent the public from representing its interest in SEC settlements. The SEC and the courts that approve settlements should go through a process whereby the public interest is evaluated along with the desires of the parties. The utilization of the *guardian ad litem* for the public interest is a possible solution. The creation of a commission to represent the public interest in government settlements would be a step toward the incorporation of the public interest.

241. *See* Finlay v. Finlay, 148 NE 624, 626 (1925).

242. The SEC has a policy of not allowing third parties to intervene. *See supra* note 16.

2. Antitrust Arena

Antitrust is another area of law which can be instructive about the incorporation of the public interest in settlement. The Tunney Act[243] requires court approval of settlement.

The Tunney Act requires that proposed settlements be filed with the district court where the case is pending and that settlement be published in the Federal Register. The filing and publication requirement notify the public and any interested parties of the impending settlement and any responses made by the government shall be filed with the district court and published in the Federal Register. The Tunney Act allows public comment about the settlement in advance of the finalization.

The Tunney Act requires that the district court make a determination that the settlement is in the public interest. Factors to be used in the determination are outlined in the Tunney Act. In the antitrust are the Tunney Act requires an opportunity for public input and assigns an evaluative role to the judiciary. The prosecutor is not the only body responsible for determining whether the public interest is served. The adoption of rules requiring publication of settlement and allowing public comment in advance of finalization would be a step toward the incorporation of the public interest.

CONCLUSION

The SEC will continue to ignore the role of the public interest in settlement negotiations unless legislative steps to incorporate the public interest are taken. Borrowing from other areas of the law will be helpful in developing methods to incorporate the public interest. As a matter of public policy, it would be prudent to appoint a guardian *ad litem* for the public interest instead of allowing the SEC to address its own self-interest instead of the public interest.

243. The Tunney Act, 15 U.S.C. § 16(b)-(d) (1994).

APPENDIX A
ORGANIZATIONAL STRUCTURE OF THE SEC